European University Institute
Department of Economics
Spring 2015

April 17 – May 15
Fridays 8:45 – 10:45[1]
Villa San Paolo

Fiscal and Monetary Policy and Institutions: Reassessing the Eurozone macroeconomic framework[2]

Ramon Marimon

The background

This (half-credit) course focuses on the design of fiscal and monetary policies when there is limited commitment and enforcement. *Monetary and Fiscal Unions* are a paradigmatic case: fiscal and monetary policies cannot be delinked but, without full commitment, linking – or, effectively, coordinating policies – is not trivial: sovereign member states can choose to leave the union (limited enforcement) or simply to not fulfill their commitments (limited commitment). Furthermore, as *the financial and euro crises* have reminded us, the "unpleasant arithmetic" goes beyond the need to jointly account for monetary and fiscal policies correctly: financial stability and within-the-union trade and financial imbalances must also be accounted for (otherwise a crisis will oblige you to do it).In addition there is a broad range of national policies that affect the 'net wealth' of a country within the union: labour & product market policies, social policies (health, unemployment, retirement, redistribution, etc.) and long-term policies (education, R&D, environment, etc.). These spillovers are a source of withintheunion free-riding and moral-hazard problems or, simply, of lack of trust and solidarity, which all weaken the union's norms and institutions.

In this perspective, the design of credible and effective fiscal and monetary policies seems daunting, and one is tempted to 'pass the ball' to 'politics and the law': after all, a union is a political construct in need of legal enforcement, and more of both seems an easy solution (e.g. European Political Union as a federal state). Unfortunately, for the EU or Eurozone (EZ), it is not a credible solution for the time being and, furthermore, the design of interdependent policies is a pervasive issue in an interdependent global economy.

Fortunately, progress has been made, both in theory and in practice. In theory, we now have better models and tools with which to design macroeconomic policies with limited commitment and enforcement. In practice, important steps have recently been taken towards redesigning the institutional architecture of EMU (fiscal compact, ESM, banking union, ECB policies, etc.). Unfortunately, in practice some of these designs seem more appropriate for a union in steady-state – where exogenous uncertainty is the only source of differences across member states - than for a union where differences are more perverse, affecting socio-economic structures (and cultures?) and policies. Similarly, theory falls short of meeting these challenges, and the debate on whether the right policies have been implemented during the financial and euro crises remains open. In sum, a broad range of open and interesting research topics!

[1] No class on May 1st, instead: Wednesday 29 April, 11:00 – 13:00
[2] The materials of this course will be in our ECO Moodle, where my office hours are also listed.

The course

The course is divided into five topics, covered roughly one a week, and in each one we will cover one element of the EU-EZ macro-architecture and some related models. Active participation in the corresponding discussions is expected. Previous reading of at least asterisked (*) references is strongly recommended. The course will be evaluated on the basis of class participation (15%) and a final short paper (85%), which can be written in groups of a maximum of 3. The paper should be a short (max 15pp.) inquiry into some facts or issues related to the topics of the course, what current economic theory has to say about them, and how they could be better addressed. Since some of the facts and issues are common domain, those planning to participate are encouraged to think about possible topics ahead of the course. The deadline for the paper is June 6 (noon).

The syllabus

1. Overview. The European Union - Eurozone macroeconomic framework. On theories of Monetary and Fiscal Unions. Lessons from the euro crisis [The Van Rompuy Report (2012)].

2. Credible 'optimal' fiscal and monetary policy with limited commitment. [The Fiscal Compact and 'austerity packages'].

3. Sovereign debt and risk sharing with limited enforcement [The European Stability Mechanism (ESM)].

4. Financial risk vs. financial stability [The EU Banking Union].

5. Conventional and unconventional Monetary and Fiscal Policies [The ECB and FRB policies during the crises. "Fiscal policy coordination/delegation in the EU?"].

The references[3]

[*3] Ábrahám, A., E. Carceles-Poveda, Y. Liu and R. Marimon (2014). On the optimal design of a Financial Stability Fund, May (work in progress).

Akaloakis, C., A. Doxiadis and M. Galenianos (2014). "The Challenge of Trade Adjustment in Greece," Yale University.

Allen, F. and E. Carletti (2013). "What Is Systemic Risk?", *Journal of Money, Credit and Banking,* 45(1) 121-127.

Arellano, C. (2008). "Default Risk and Income Fluctuations in Emerging Economies, *American Economic Review* 98(3): 690-712.

Auerbach, A. J. and Y. Gorodnichenko (2013). "Output spillovers from fiscal policy". *American Economic Review: Papers and Proceedings,* 103(3): 141-146.

[3] Data resources and further references can be found in the EUI Library "The Euro: information resources and bibliography". Useful links for facts and policy debates are: The Cooley et al. "European Economic Snapshot" and Voxeu (EU Topics).

Baaso, H.S. and J. Constain (2013). "Fiscal Delegation in a Monetary Union with Decentralized Public Spending," Banco de España, Doc. Trabajo 1311.

Beetsma, R. M., and H. Jensen (2005). "Monetary and fiscal policy interactions in a micro-founded model of a monetary union," Journal of International Economics, 67(2), 320–352.

Beetsma, R. M. W. J., and A. L. Bovenberg (1999). "Does monetary unification lead to excessive debt accumulation?," Journal of Public Economics, 74(3), 299–325.

Bi, H. and E. M. Leeper (2013), "Analyzing Fiscal Sustainability." Bank of Canada, WP 2013-27.

Black, S.W. (2010). "Fixing the flaws in the Eurozone," Voxeu.

Calmfors, L. and S. Wren-Lewis (2011). "What should fiscal councils do?", *Economic Policy,* 26(68): 649-695.

Calvo, G. (1988). Servicing the Public Debt: The Role of Expectations. *American Economic Review* 78(4): 647-661.

[*1] Chari, V.V., A. Dovis and P. Kehoe (2013). "Rethinking Optimal Currency Areas," Federal Reserve Bank of Minneapolis, Res. Dept. Staff Report.

Chari, V.V. and P. Kehoe (2010), 'Sophisticated Monetary Policies', *Quarterly Journal of Economics* 125(1), pp. 47-89.

[*2] Chari, V.V. and P. Kehoe (2007), 'On the Need for Fiscal Constraints in a Monetary Union', *Journal of Monetary Economics* 54(8), 2399-2408.

Christiano, L. J., M. S. Eichenbaum, and M. Traban dt (2015). "Understanding the Great Recession." *American Economic Journal: Macroeconomics*, 7(1): 110-67.

Cochrane, J.H. (2014). "Towards a run-free financial system," University of Chicago.

Cole, H., and T. Kehoe, (2000). Self-Fulfilling Debt Crises. *Review of Economic Studies* 67(1): 91-116.

[*4] Cooley, T., R. Marimon and V. Quadrini (2014). "Risky Investments with Limited Commitment," EUI

Correia, I.H, E. Farhi, J.P. Nicolini and P. Teles (2013), 'Unconventional Fiscal Policy at the Lower Bound', *American Economic Review*, 103(4): 1172-1211.

Corsetti, G., K. Kuester, Keith, A. Meier, André, and G. Müller (2013). "Sovereign Risk, Fiscal Policy, and Macroeconomic Stability". *Economic Journal* 123(566): F99-F132

Corsetti, G., K. Kuester, A. Meier and G. Müller, 2014, 'Sovereign risk and belief-driven fluctuations in the euro area', *Journal of Monetary Economics*, vol. 61: 53-73.

Cottarelli, C. (2011), "The Risk Octagon: A Comprehensive Framework for Assessing Sovereign Risks."
http://www.imf.org/external/np/fad/news/2011/docs/Cottarelli1.pdf

Cui, W., and S. Radde (2014).: Search-based Endogenous Illiquidity and the Macro," working paper, DIW Berlin.

[*2] Diaz-Giménez, J., G. Giovannetti, RMarimon, and P.Teles (2008). Nominal Debt as a Burden of Monetary Policy, Review of Economic Dynamics, 11, 3, 493-514.

[*1 Intro.] Eichengreen, B. (2015). *Hall of Mirrors: the Great Depression, the Great Recession, and the uses – and misuses – of history.* Oxford U. Press.

[*1] Farhi, Emmanuel and Ivan Werning. "Fiscal Unions." working paper, MIT (2013)

Fernández-Villaverde, J. and L. Ohanian (2010). "The Spanish Crisis from a Global Perspective." FEDEA wp 2010-03.

Freixas, X. L. Laeven, and J.L. Peydro (2015). *Systemic Risk, Crises and Macroprudential Policy*. MIT Press (June 2015).

[*5] Gaballo, G. and R. Marimon (2014). Breaking the Spell with Credit-Easing: Self-Confirming Credit Crises in Competitive Search Economies, European University Institute, May (work in progress).

Galí, Jordi and Monacelli, Tommaso (2008). Optimal monetary and fiscal policy in a currency union. *Journal of International Economics* (76) 1: 116-132.

[*4] Geanakoplos, J. (2014). "Leverage, Default, and Forgiveness: Lessons from the American and European Crises," *Journal of Macroeconomics,* (39): 313-333.

Geanakoplos, J. (2011). "What Is Missing From Macroeconomics: Endogenous Leverage And Default." Cowles Foundation Paper 1332.

[*5] Gertler, M. and P. Karadi (2011). A model of unconventional monetary policy. *Journal of Monetary Economics* 58(1), pp.17-34.

Hagen, Jürgen von (2013). Fault Lines in the Public Sector. Paper presented at the IMF First Statistical Forum, Washington DC.

Jimenez, G., S. Ongena, J.L Peydró (2014) "Hazardous Times for Monetary Policy: What do 23 Million Loans Say About the Impact of Monetary Policy on Credit Risk-Taking?" *Econometrica,* 82 (2), 463-505.

Kiyotaki, N., and J. Moore (2012). "Liquidity, Business Cycles, and Monetary Policy", NBER Working Paper, 17934.

Morten O. and V. Sterk (2013), "Job Uncertainty and Deep Recessions", working paper, University College London.

[*4] Nakajima, M. and J.V. Ríos-Rull (2014). "Credit, Bankruptcy and Aggregate Fluctuations," NBER wp20617.

Ohanian, L. and A. Raffo (2012). "Aggregate hours worked in OECD countries: New measurement and implications for business cycles," *Journal of Monetary Economics,* 59, 40-56

Roch, F., and H. Uhlig (2011). The Dynamics of Sovereign Debt Crises and Bailouts. Mimeo.

[*1] Sargent T. J. (2010). Where to draw the lines: stability vs. efficiency. New York University.

[*1] Sargent, T. J. (2012). "Nobel Lecture: United States Then, Europe Now," *Journal of Political Economy*, 120(1), 1 - 40.

Wolf, M. (2014). *The Shifts and Shocks: What we've learned – and have still to learn – from the financial crisis.* Penguin.

Wyplosz, C. (2013). "Europe's Quest for Fiscal Discipline," *European Economy Economic Papers,* 498.