Summary for non-specialists
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The performance of simple fiscal policy rules in monetary union

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This paper analyses the potential of simple fiscal policy rules to stabilise cyclical fluctuations and reduce the welfare cost of supply and demand shocks in monetary union. The focus is on the stabilisation of asymmetric shocks at the level of small member states, which are not stabilised by the reaction of the common monetary policy to area-wide variables.

The paper reconsiders a classical question of the currency union literature, i.e. the importance and potential of fiscal policy to stabilise asymmetric shocks. It uses two-region DSGE model with nominal and real rigidities analyses for a small open economy and the rest of monetary union. The model includes financial, goods and labour market frictions and is calibrated to match data moments of small euro area countries over the period 1999-2009. The analysis considers simple instrument rules for government purchases, transfers, and consumption, labour and capital taxes.

The paper finds a dichotomy in the welfare effects of fiscal instrument rules reacting to asymmetric shocks for liquidity-constrained and intertemporal optimising households, i.e. policies enhancing the welfare of one group tend to reduce the welfare of the other one. Moderate average welfare gains from optimal policy contrast with large losses from non-optimal policy. The potential welfare gains for liquidity-constrained households from stabilisation policies are much larger, however, as those typically found in the literature in models of that only include intertemporally optimising agents.

Fiscal rules responding to employment fluctuations may be preferred to rules responding to indicators of price competitiveness, because optimal policy in the former corresponds more closely to the idea of countercyclical stabilisation. The paper also emphasises the strong impact of the budgetary closure rule for government debt/deficit stabilisation on the welfare gains from business-cycle stabilisation. Changing the government debt/deficit closure from (idealistic) lump-sum taxes to, e.g., distortionary labour taxation lowers the potential welfare gain from fiscal stabilisation policies and inverts the optimality results for consumption and capital taxes.