Robert Schuman Centre

European Unemployment: Macroeconomic Aspects

Fiscal Policy, Real Exchange Rates and Monetary Union

RAY BARRELL
and
JAMES SEFTON

RSC No. 97/40

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Barrell/Sefton: *European Unemployment: Macroeconomic Aspects Fiscal Policy, Real Exchange Rates and Monetary Union*

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Introduction*

Europe is approaching the point at which decisions have to be made about the construction of a monetary union in Europe. Once exchange rates are fixed real exchange rate adjustment will have to come through changes in relative prices, and as Europe appears to exhibit considerable nominal inertia this process can be expensive in terms of lost output. Hence it is important to make an assessment of each potential member's sustainable real exchange rate before nominal rates are irrevocably fixed. This note sets out some estimates of such exchange rates, and suggests that many European economies are currently close to their sustainable exchange rates. However, the sustainable exchange rate is not immutably fixed. The Maastricht fiscal criteria are seen as central to the construction of a monetary union in Europe. Constraints on fiscal policy are seen as essential to the successful management of the union, as can be seen from the strength of the penalties set out in the stability pact. Some countries will have to make considerable moves to consolidate their public finances, and this will in turn change the real exchange rate that they can sustain.

This paper develops a theoretical model that allows us to lay some foundations for the evaluation of sustainable or equilibrium real exchange rates (EERs). We construct a model of a small open economy and analyse its properties. We attempt to reconcile stock and flow analysis in this framework, and in particular we look at the relationship between fiscal policy and the (equilibrium) real exchange rate, drawing on Barrell and Sefton (1997).

A Small Open Economy Model

We base our analysis on a data-based, extended version of the Mundell-Fleming model, drawing on Buiter and Miller (1981) and on the papers contained in Buiter (1990). The policy conclusions drawn from this model depend upon the characteristics of the world we are describing. In order to calibrate the magnitudes involved we use the estimated model NiGEM, rather than a purely theoretical construct, to undertake some policy analyses. The structure of NiGEM can be seen as the empirical equivalent of the extended Mundell Fleming model, and its properties closely reflect those of the theoretical model[1]. In this paper we wish to investigate the effects of fiscal policy on real exchange rates both in the

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[1] In its normal mode of operation exchange rates and financial markets, for instance, are forward looking, but this aspect is not essential to the analysis of the long run structure

short run and in the longer term. Many of these fiscal policy issues are discussed in Barrell and Sefton (1997), and we only summarise our results here. We choose to look at the effects of fiscal policy on sustainable exchange rates in a small country, as this helps give clarity to our conclusions.

In order that our theoretical model is general we will set it up with wealth effects and the possibility that we can introduce a weak form of Ricardian equivalence. We collapse the demand side of the world into one (IS style) relationship where output, y, depends negatively on the real interest rate ($r - \dot{p}$) and positively on the real exchange rate. We also include effects from net private sector financial wealth, z , government spending, g , and (potentially a negative effect from) government bonds, b , and we have utilised a log approximation to the linear wealth identity[2] i.e.

$$y = -\gamma(r - \dot{p}) + \delta(e - p) + \varepsilon z + g - \eta b \qquad (1)$$

We assume that increases in government spending, which raise current disposable income, will also raise consumption. We concentrate on the link between fiscal policy and the current account.

Our wage price system can be reduced to a relatively simple, sluggish adjustment price equation (2) where expected inflation, π is mediated by an effect from aggregate demand. We can write an aggregate augmented inflation equation.

$$\dot{p} = \psi y + \pi \qquad (2)$$

We assume that the demand for money (3) depends upon income and the interest rate r, and rm is the rate of return on money, which we can assume to be zero.

$$m - p = ky - \lambda(r - rm) \qquad (3)$$

We also assume that the rate of growth of the stock of money is determined by its target growth rate (4)

$$\dot{m} = \pi \qquad (4)$$

[2],. For expositional clarity we have suppressed t in our analysis, and we have assumed that Z=2B, where B is the level of the bond stock and Z is the level of the wealth stock. In general our results depend upon private sector foreign assets always being positive, and hence significantly larger than the bond stock.

We need two asset markets in order to close our model. We have assumed for expositional simplicity that the private sector has a well defined wealth/income equilibrium, and that foreign assets and domestic government bonds are the only assets. Hence if the government issues bonds they will either be held by foreign residents or domestic residents will reduce their foreign assets, and hence the national net stock of foreign assets is[3].

$$f = (2z - b). \qquad (5)$$

We assume that the exchange rate follows the open arbitrage path with an asset related risk premium:-

$$\dot{e} = (r - \tilde{r}) + \mu(2z - b) \qquad (6)$$

where $\tilde{r}$ is the rate of interest on foreign assets. As e is the effective exchange rate, a rise in private sector foreign assets causes the exchange rate to appreciate, and a rise in the government debt stock causes an ongoing real depreciation through its effect on the risk premium. The accumulation of private sector assets (and hence the current account) can be written as:-

$$\dot{f} = (\tilde{r}^{b} - \tilde{r}\, g^{b})\, f + \tilde{r} - \alpha y + \beta(e - p) \qquad (7)$$

Where a superscript "b" denotes the base value for a variable, and $\tilde{r}\, g$ is the nominal growth rate in the rest of the world. The base value has to be included because the introduction of wealth stocks imparts some degree of base dependency into the analysis of shocks such as a change in the world interest rate. The first two terms of the RHS of (7) represent the effects of debt service or debt interest receipts on the current account. We also assume that demand will worsen the current account and that an appreciation of the real exchange rate (as defined here) will improve the current account.

If there were no government spending and no government debt stock we would have three state variables in our system. However, we wish to analyse the effects of fiscal policy, and hence we have to write down the private sector asset accumulation equation (as distinct from the foreign assets accumulation equation), where B is the long run government to bond stock ratio on the base.

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[3] If F=Z-B then log(F) can be approximated by f=1/(1-t)*z - t/(1-t)*b where t=B/Z on the base and lower case letters denote logs. If Z=2B then t=0.5, and we may write f=2z-b.

$$\dot{z} = (r^{b}-rg^{b})\, z + (r - \dot{p}) + g / B \qquad (8)$$

where the superscript "b" once again denotes the value of the base trajectory, and rg is the nominal rate of growth of income in the domestic economy. The debt accumulation equation consists of interest payments on debt, and the primary deficit (net of any high powered money issue), g, divided by the long run bond stock.

In order that the government debt stock does not rise without bounds we also introduce a feedback rule for government spending.

$$g = \chi(b - bt) \qquad (9)$$

Where bt is the target debt stock. In a dynamically efficient economy a permanently sustained positive value for g will cause the debt stock to explode, and hence the intertemporal budget constraint is violated. This feedback rule allows us to prevent this happening if we wish.

If we had no government we could put (2) and (4) together in order to write an expression for $\dot{l} = \dot{m} - \dot{p}$, (5) and (2) together to write an expression for $\dot{c} = \dot{e} - \dot{p}$, and (6) would be sufficient for the current account. However; the existence of b and g changes our set of state variables. We have to write:-

$$\dot{l} = \dot{m} - \dot{p} = - \psi y \qquad (10a)$$

$$\dot{c} = \dot{e} - \dot{p} = (r - \tilde{r}) + \mu(z - b) - \psi y - \pi \qquad (10b)$$

$$\dot{f} = \dot{z} - \dot{b} = (r^{b} + rg^{b})\, f + (r - \dot{p}) - \alpha y + \beta(e - p) \qquad (10c)$$

Where $\dot{f}$ is the current account, which is the sum of private and public sector accumulations of foreign assets. We also have to take account of (8) and (9) and hence we have a four equation dynamic system to solve. In Barrell and Sefton (1997) we analyse this system and demonstrate that the following conditions must hold if the system is to embody a well-defined solution:

- $(k - \lambda\psi) > 0$ which is the Cagan condition on the slope of the LM curve,
- $(\beta - \delta\alpha) > 0$ which is the extended Marshall Lerner condition
- $[\beta(\varepsilon+\mu(B+\gamma)) - \delta(\tilde{r}^{b} - \tilde{r} g^{b})] > 0$ which is a wealth equilibrium condition[4],

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[4] Once again we have assumed for simplicity of exposition that Z=2B

- $\chi > (r^b - rg^b)$, which is a debt stability condition,

The third condition requires that the marginal propensity to consume out of wealth must be sufficiently high that the accumulation of interest receipts from existing holdings of wealth does not cause the wealth stock to grow without bound (a "no misers" condition). The last condition is required for the stability of the debt process itself, requiring the feedback to exceed the excess of the interest rate over the growth rate. In a dynamically efficient economy the feedback must be positive. Hence we can claim that a necessary condition for saddlepath stability in an extended Mundell Fleming model with a debt issuing government is the imposition of an adequate solvency constraint (g = χ(b - bt)) on the primary budget deficit.

As our intention is to analyse the long run of the system, we can set $\chi \to \infty$ and inspect the long run results system[5]. In this paper we are particularly interested in the effect of bt, the debt target on the real exchange rate, c, and the derivative can be written as (See Barrell and Sefton 1997) :

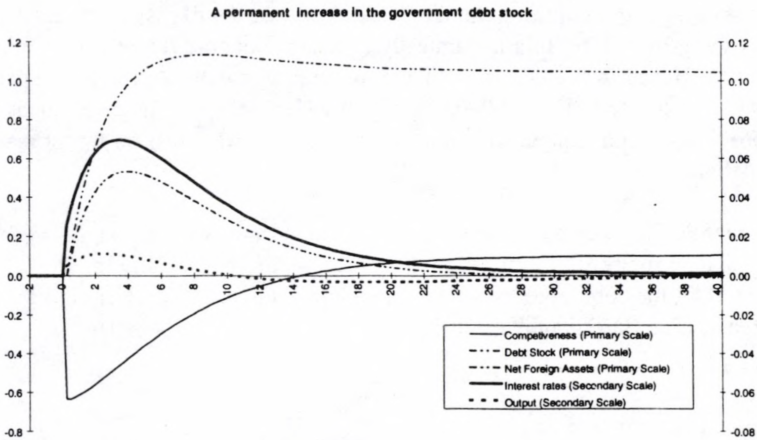
$$\frac{\partial c}{\partial bt} = \frac{(\tilde{r} - \tilde{r}g)(2\varepsilon - (r^b - rg^b)B - \eta)}{\beta(\varepsilon + \mu(B + \gamma)) - \delta(\tilde{r} - \tilde{r}g)}$$

The derivative of competitiveness with respect to the target is clearly positive, and hence in the long run a change in the debt target causes c to rise, and hence a higher debt stock causes the economy to have to be more competitive. In other words, in the long run a higher debt stock requires a lower relative price level.

It is useful to check that our system is stable, and then look at the dynamics of adjustment in a simple model of the economy. We have chosen a simple model with little Ricardian equivalence that is calibrated of the NIESR model of the UK economy. Chart one plots the evolution of the bond stock b, the stock of private sector assets z, and the real exchange rate, c, in response to an increase in bt. As we have wound the solvency constraint up very tight for illustrative purposes the actual bond stock quickly achieves its target. The stock of private sector assets initially rises, and then falls back almost to base, as we have assumed Ricardian effects are weak. The real exchange rate initially jumps down (appreciates) and then rises along the arbitrage path. It rises above base in the long run (has

[5] In the long run the debt stock will not quite equal the target debt stock with our feedback rule. There will be a small offset that is a complicated function of the variables and parameters of the model. As $\chi \to \infty$ the size of the offset tends to zero, and hence this assumption allows us to look directly at he long run of the system without an effect from the offset.

depreciated) in order that the primary current (or trade) account surplus is large enough to ensure that interest on the extra external debt can be paid. In this case (almost) all the new debt issued is held abroad. The stronger is Ricardian equivalence, the less the effect on the exchange rate, and the less the effect on the stock of debt held abroad.



Our simple model can be seen as the theoretical basis for the existence of an equilibrium real exchange rate that depends on the wealth equilibrium of the private sector, the size of the government bond stock and on the competitiveness elasticity summarised in the current account equation, as well as the absorption effect from the simple IS curve. The economy is at its equilibrium real exchange rate when output and inflation are on their long run trajectories (which may be described as internal balance), and when the current account (or external balance) is consistent with the government debt stock and the wealth stock equilibrium embedded in the economy, which is determined by the parameters of the IS curve. Hence, if we wish to evaluate real exchange rate equilibrium in an economy we have to estimate internal balance and external balance relationships, and we turn to this below.

The Evaluation of Equilibrium Exchange Rates

We are particularly interested in equilibrium exchange rates in Europe, as the identification of real exchange rates, or relative price indicators is central to the evaluation of the short run costs of setting up a monetary union in Europe. In order to evaluate the significance of our results we have to embed them in a model of the European economies. In particular we have to evaluate what real alternative real exchange rate trajectories would have been sustainable. We need to analyse the long run structure of a model similar to our theoretical construct. In Barrell and Wren Lewis (1989) and Barrell and in't Veld (1991) we used a large econometric model of the advanced economies to evaluate the trajectory for the Fundamental Equilibrium Exchange Rate (FEER or in IMF parlance, the DEER). These analyses were designed for a series of exercises undertaken for Williamson (1994).

We do not use the concept of Purchasing Power Parity for several reasons, although it is not necessarily inconsistent with the concept of the EER. If supply and demand elasticities in international trade are (in the long run) sufficiently large then the economy will be attracted to a relative price level that is justified by PPP. However, the long run may be rather longer than we feel is useful for policy analysis, because it may have to involve the relocation of economic activity. A common approach is to demonstrate that prices and the exchange rate cointegrate, but this cannot be interpreted as evidence in favour of PPP. The existence of an equilibrium real exchange rate should not be doubted, but all we may conclude from cointegration results is that it may be above or below PPP.

Empirical work on trade volumes and prices tends to find that competitiveness elasticities are not great. However, equilibration does not only come about by the adjustment of trade volumes. PPP may be brought about by the relocation of economic activity. Barrell and Pain (1996) do find some evidence that relative costs affect foreign direct investment (FDI) flows, although such effects are small and slow acting. It is clear that many countries can affect their current real exchange rate for some periods of time, even if there are strong forces driving the real exchange rate back to equilibrium. The manipulation of the real exchange rate can be, and has been, used as a tool for increasing exports and accumulation.

In order to evaluate the EER we require a set of empirical relationships determining internal balance, external balance and asset accumulation These can be constructed from our model. The **external balance** relationship is equivalent to our overseas asset accumulation condition above and we require trade volume and price equations:

XVOL = f(World Demand, Relative Prices)

MVOL = g(Domestic Demand, Relative Prices)

PX = h(Domestic Prices, World Prices, Capacity Utilisation)

PM = k(Domestic Prices, World Prices)

CB = CB(Relative prices, World Demand, Capacity Utilisation, World Prices)

For given levels of world and domestic demand along with World Prices for commodities such as oil, the real exchange rate, as described by relative prices, will deliver a current account balance. The factors involved in the **internal balance** relationship will vary depending on the structure of the economy and the factors involved in the wage bargaining relationship. We require wage, price and demand relationships:

PD = f_1 (Domestic Costs, Capacity Utilisation,)

WC = g_1(Domestic Prices, Real Exchange Rate, Unemployment,)

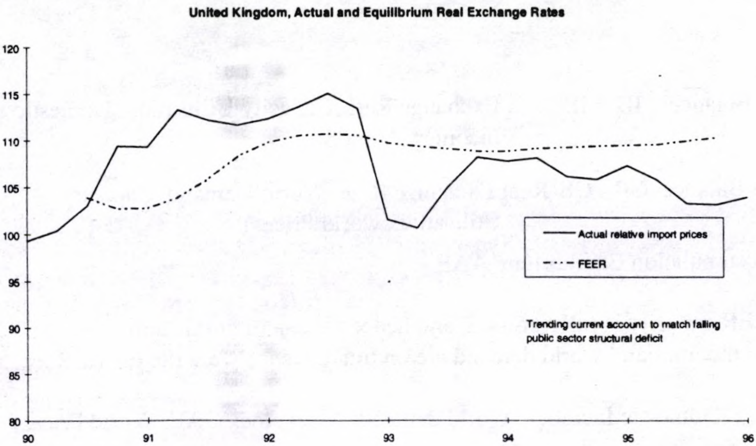
DD = h_1(Domestic Incomes, Asset Stocks,)

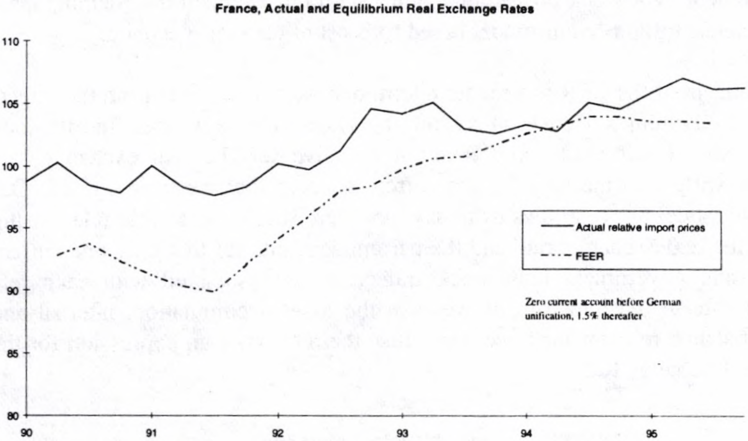
IB = IB(Real Exchange Rate, Capacity Utilisation, Domestic Incomes, Asset Stocks)

These are described by our IS, inflation and labour market relations and labour markets discussed above. In early analyses of EERs it was assumed that the wage bargain displayed a real exchange rate wedge, and hence internal balance was a function of the real exchange rate. However, as Barrell (1993) argues, the empirical and theoretical support for this proposition is weak. The level of domestic capacity affects wages through unemployment, and prices through capacity utilisation. If capacity increases then domestic wages and prices would have to be lower than they would otherwise have been. However, if the economy is operating at full capacity then there may be no domestic forces putting pressure on the real exchange rate. If the economy is operating at capacity, world output is on its underlying trend, and world prices are on a stable trajectory then we should have external and internal balance

However, for the EER to be sustainable, or on a sustainable trajectory, as we argue above, we require that the economy is at an **asset equilibrium.** This will depend, inter alia, on the size of the government debt stock, and the level of overseas assets. It will also depend on the time profile of domestic income and spending, with countries having long term accumulation needs running balance of payments surpluses. Unless trade elasticities are extremely large this requires that the real exchange rate accommodates the need for accumulation. Our knowledge of government debt stock projections, along with our evaluation of demographic developments, influence our model based forecast of the world economy.

As the concept of the EER is a medium term one we can abstract from the effects of short run dynamics. Hence, in solving the system above we can find the long run structure of our model and invert it to solve for the real exchange rate consistent with the trajectory for the current account that we have chosen. Our theoretical model above allows us to say that there should be a clear relationship between the real exchange rate and the current account, but that only one current account (and government debt stock trajectory) is associated with each real exchange rate in the long run. If we take the asset accumulation, internal and external balance relationships, we can utilise them to write an expression for the EER Real Exchange Rate





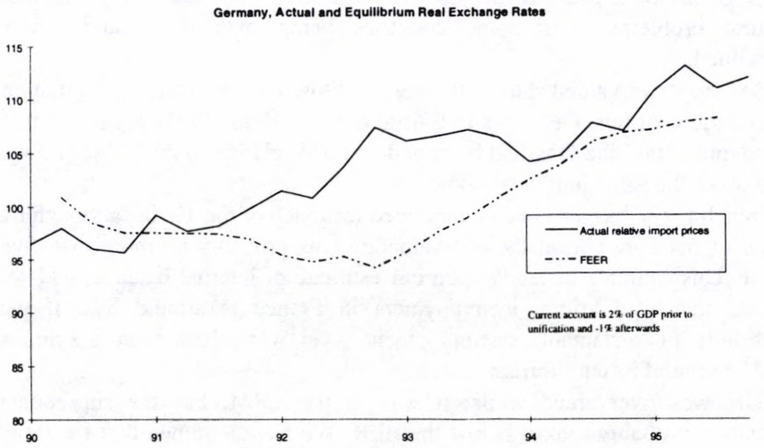
Internal Balance IB = IB(Real Exchange Rate, Capacity Utilisation, Domestic Incomes, Asset Stocks)

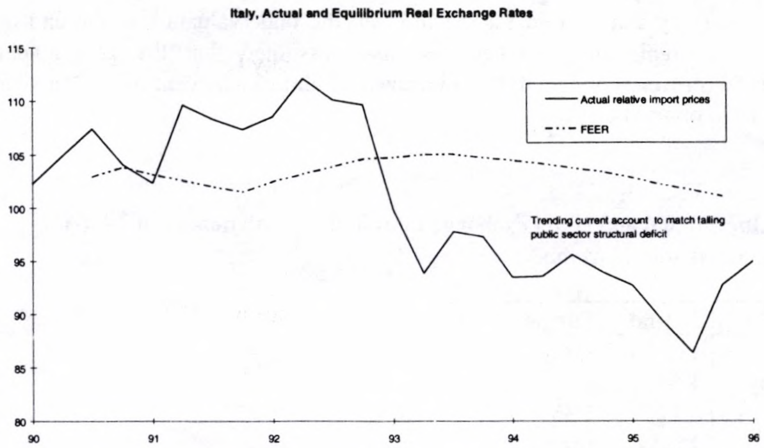
External Balance CB= CB(Real Exchange Rate, World Demand, Capacity Utilisation, world Prices)

Asset Accumulation Equilibrium AAE

At the EER capacity is fully utilised, and hence we can omit this term, and domestic incomes and world demand are on trend. Hence we write the EER as:

EER = F(Domestic Incomes, World demand, Asset stocks, AE, World Prices)





Our French and German asset equilibria both change around the time of German unification, as do our other European targets, because German outflows were diverted, and this has to be matched elsewhere. We have a trending asset equilibria for the UK and for Italy to reflect the structural improvements in the underlying budgetary position that we believe were in place.

The charts plot our EERs estimates for the major European. These estimates are for effective exchange rates, and Table One gives details of our bilateral US dollar EERs in the fourth quarter of 1996.

- The ECU basket appears to be just around correct, but this masks internal structural problems, with some countries being overvalued, and others undervalued.
- The DM was overvalued during the early 1990s, but relatively low inflation removed much of this. Our work in Barrell and in't Veld (1991) suggested that prior to unification the DM had been undervalued relative to the EER, and we would make the same judgement now.
- The French Franc has also been overvalued for much of the 1990s, although by the end of our data period the overvaluation was probably no more than five percent. This estimate depends upon our estimate of internal balance, and we calculate that equilibrium unemployment in France is around 8%. If the equilibrium, or sustainable unemployment level were 10% then the Franc would be around its equilibrium.
- The UK was overvalued whilst it was in the ERM, but the subsequent devaluation probably took it below the EER. We have assumed that the trend budget deficit improved by around half a percent of GDP after 1993.
- A similar story can be told for the lire, but the undervaluation at the end of 1995 was significantly greater. We have assumed that the government structural (or trend) budget deficit improved by almost a percent of GDP a year from 1990 onwards.

Table One. Actual and target exchange rates in the fourth quarter of 1996 (US dollar bilateral, mid November)

	Actual	Target
Japan	113.00	116.89
Germany	1.54	1.54
France	5.12	5.36
Italy	1525	1565
UK	1.65	1.57

(Note the UK exchange rate is £/$)

Conclusions

In this paper we have shown that in a small open economy model there is a connection between the target government debt stock and the equilibrium real exchange rate. A change in the target changes the equilibrium real exchange rate (unless there is full Ricardian equivalence). This is significant in the discussions of monetary union in Europe, as the criteria for membership of the union require significant changes in fiscal policy in a number of countries. Hence, if in late 1996 exchange rates were close to their equilibrium given current debt stocks and private sector behaviour, those equilbria will change as debt stocks fall to below 60 percent of GDP. Countries with large debt stocks, such as Italy and Belgium, will require large increases in their real exchange rates as they approach their fiscal targets.

Once monetary union is formed (or rather once nominal exchange rates are proximately fixed) real exchange rates have to adjust through the movement of relative prices. Our simple calibrated model suggests that for each one percent of GDP change in the debt stock target the real exchange rate has to change by 0.1 percent. A fall of ten percent in the debt stock target would therefore require a fall in the real exchange rate (an appreciation) of around one percent. Hence if Italy, say, which is well represented by our calibrated model, is to cut its debt stock from 120 percent of GDP to 40 percent of GDP its real (equilibrium) exchange rate will have to rise by 8 percent, and hence its inflation rate must exceed that of the rest of Europe by one percent for eight years. Given other structural adjustments in the economy this could make the inflation differential exceed 1.5 percent, and hence the attempt to achieve the Maastricht targets of a fixed nominal rate and an acceptable debt stock may well cause such an economy to be excluded from monetary union because it fails the inflation criteria.

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