Macroeconomic policies in an open economy

- We have seen that monetary and fiscal policies affect the interest rate (i) in the short run: expansionary MP reduce i and viceversa, while expansionary fiscal policies increase i and viceversa.
- The change in the interest rate affects investment spending, but also the balance of payments: immediatly via the capital account and the foreign exchange rates and more slowly via the trade balance (i.e. exports and imports of goods and services).
- The foreign exchange rate is the price of one country's currency in terms of another. The actual exchange rate is determined by the interaction of supply and demand conditions in the foreign exchange market.
- Exchange rates can be fixed at a predetermined level or they can be flexible to reflect changes in demand.
- In an open economy the *short run* effectiveness of monetary and fiscal policies depends also on the **foreign exchange rate** regime (fixed vs flexible foreign exchange rates).
- According to the Purchasing Power Parity theory, in the *long run*, however, nominal exchange rates depend only on the ratio of relative price levels, and macroeconomic policies do not affect real variables (output and employment).

Monetary policies in an open economy

- **Monetary policies in the short run are more effective with flexible exchange rate, while they are ineffective with fixed exchange rates.**
- Example: an expansionary monetary policy reduces the interest rate relative to the interest rates of other countries, if capital mobility is high, capitals flow to other countries with higher i and the capital account of the balance of payments worsens. This reduces the demand for the country's currency relative to its supply and there is a pressure for the depreciation of the country's currency:

→ with *flexible exchange rates* the national currency depreciates and exports increase, improving the trade balance and monetary policy is more effective because the decline in i induces an increase in both Investment spending and in Exports. However in the long run the increase in inflation , reduce the country competitiveness.

→ with *fixed exchange rates*, instead, the Central Bank has to intervene to avoid the currency depreciation by buying the national currency and selling foreign currencies, thus reducing money supply and increasing the interest rate up at the initial level: the initial expansionary monetary policy is completely reversed. With fixed exchange rates, each country monetary policy is endogenous and depends on the balance of payment

Fiscal policies in an open economy

- **Fiscal policies in the short run are more effective with fixed exchange rates, while they are ineffective with flexible exchange rates.**
- Example: an increase in public spending G → increases i relative to the other countries' → this immediately induces an increase in capital inflows which improve the capital account of the balance of payments and the country's currency appreciates relative to the others:

→ with *flexible exchange rates*, the currency appreciation reduces exports (they become more expensive in others currencies) and increase imports (which become cheaper), thus the increase in G not only crowds out Investment spending, but also exports

→ with *fixed exchange rates*, the exchange rate cannot appreciate and the Central Bank has to intervene buying foreign currencies, thus increasing money supply and reducing the interest rate at the initial level.

- In order to support to exchange rate stability, monetary policy has to be expansionary and increases the effects of the fiscal policy: the non increase in i means that there is no crowding out of investments and exports. However inflation increases and this may reduce in the medium-long run the competitiveness of the country and deteriorate its trade balance.

Monetary and fiscal policies in the EURO area

- The European Union is a political and economic community of 27 member states.
- It comprises a *Single Market* guaranteeing the freedom of movements of people, goods and services, capital; maintaining common trade, agricultural and regional development policies.
- The euro was launched in 1999 and euro notes and coins were issued in year 2002 in 13 member states.

The euro

- 13 out of the 27 EU member states have adopted the same currency, the euro. These countries have a single currency, a common interest rate and a common Central Bank.
- This choice implies no national control over the exchange rate of the euro
- The entry criteria for the euro include two years of prior exchange rate stability, by participating to the Echange Rate Mechanism (ERM), and adopting EU targets in relation to interest rates, budget deficits, debt to GDP ratio and inflation
- In recent years the euro is appreciating against the dollar and holdings of euro have been growing in the world, so that some economists think that if the eurozone continues to enlarge and/or the US dollar continues to fall, the euro may become the main reserve currency in the world.

Monetary policies in the EURO area

- The European Central Bank has full responsibility for the euro area monetary policy, including setting benchmark interest rates and managing the euro area's foreign exchange reserves (i.e managing the euro exchange rate versus the other currencies)
- Priority is price stability. Inflation targeting: year on year inflation rate below 2% on the medium run.
- Other objectives are secondary (growth, employment,…)

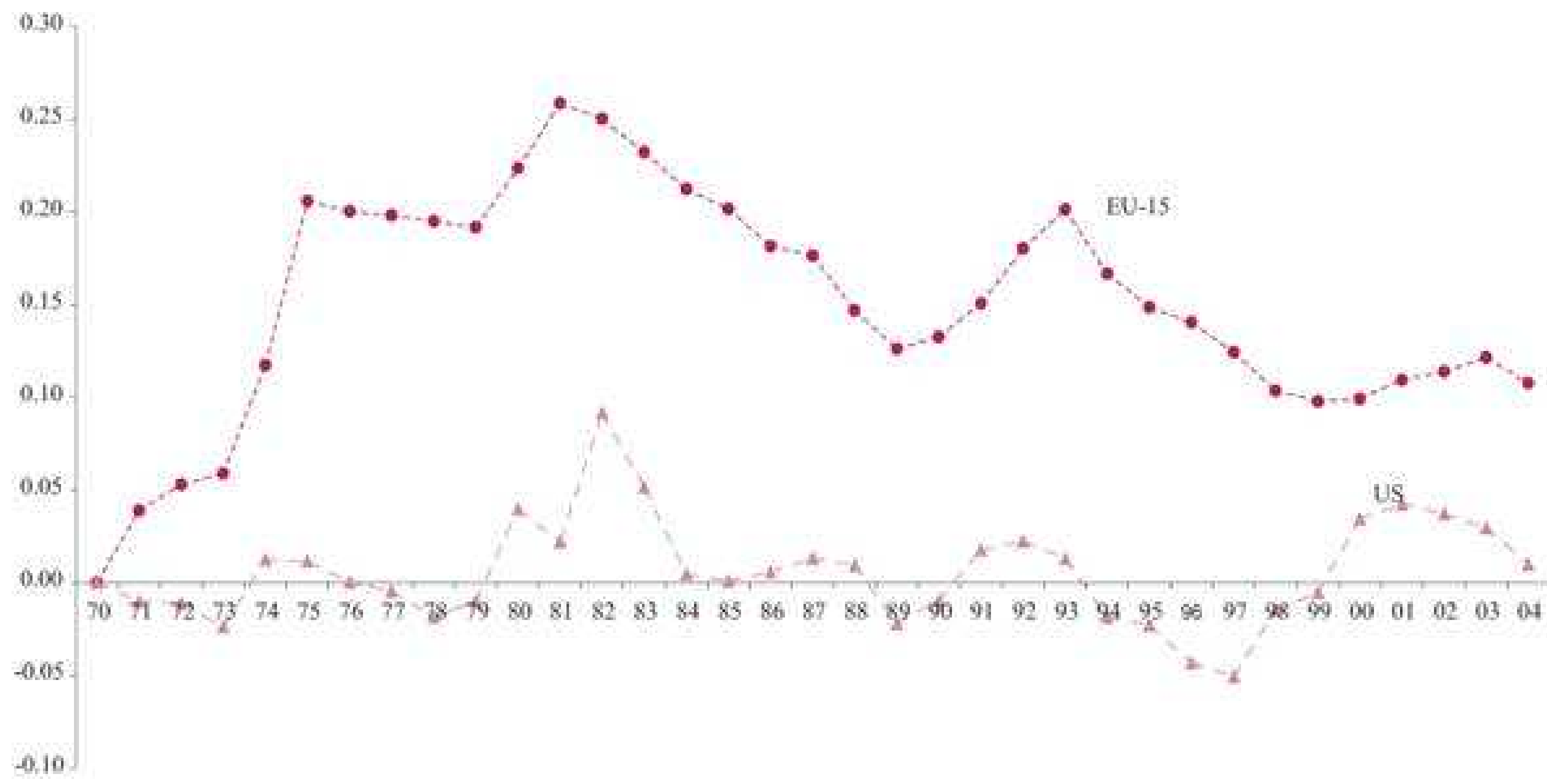
Fiscal policies in the EURO area

- Fiscal Policies are still pursued by Member States, but European countries participating to the European Union have to respect a *Stability and Growth Pact (SGP)* concerning the size of the government deficit and debt in relation to national GDP.
- The SGP rules that EU member countries (and especially those in the euro-area) keep their budget close to balance or in surplus. Budget deficits should not exceed 3% of GDP and that the public debt to GDP ratio should not exceed 60%, unless exceptional macroeconomic conditions are happening (such as for example a recession which reduces GDP by more than 2% in a year).
- Countries which do not respect the Pact should pay fines to the EU (but not applied).

Effects of the EU macroeconomic policies

- Macroeconomic policies in the EU have been targeted to keeping inflation low, this has contributed to reduce inflation expectations and to moderate wage increases: for example despite a surge in energy prices, inflation remained contained in the last period. Wage moderation has been also due to international competitive pressures.
- There is a debate on the effectiveness of these policies on the real variables: growth and employment.
  - ➢ according to some economists the policy stance has been too restrictive, thus hampering growth in GDP and employment;
  - ➢ according to others this has instead helped the reduction of the long run unemployment rate.
- The discussion relates to the fact that economic integration and greater competition may increase growth differentials across EU countries and may have adverse effects on labour markets.
- In addition inflation is due to global factors (which cannot be controlled by single countries) and structural factors which operate on the supply side (core inflation) and should be dealt with supply side policies.

Chart 73 – Real wage gap/pressure indicator (1970=0)



Source: DG ECFIN, Ameco and own calculations.

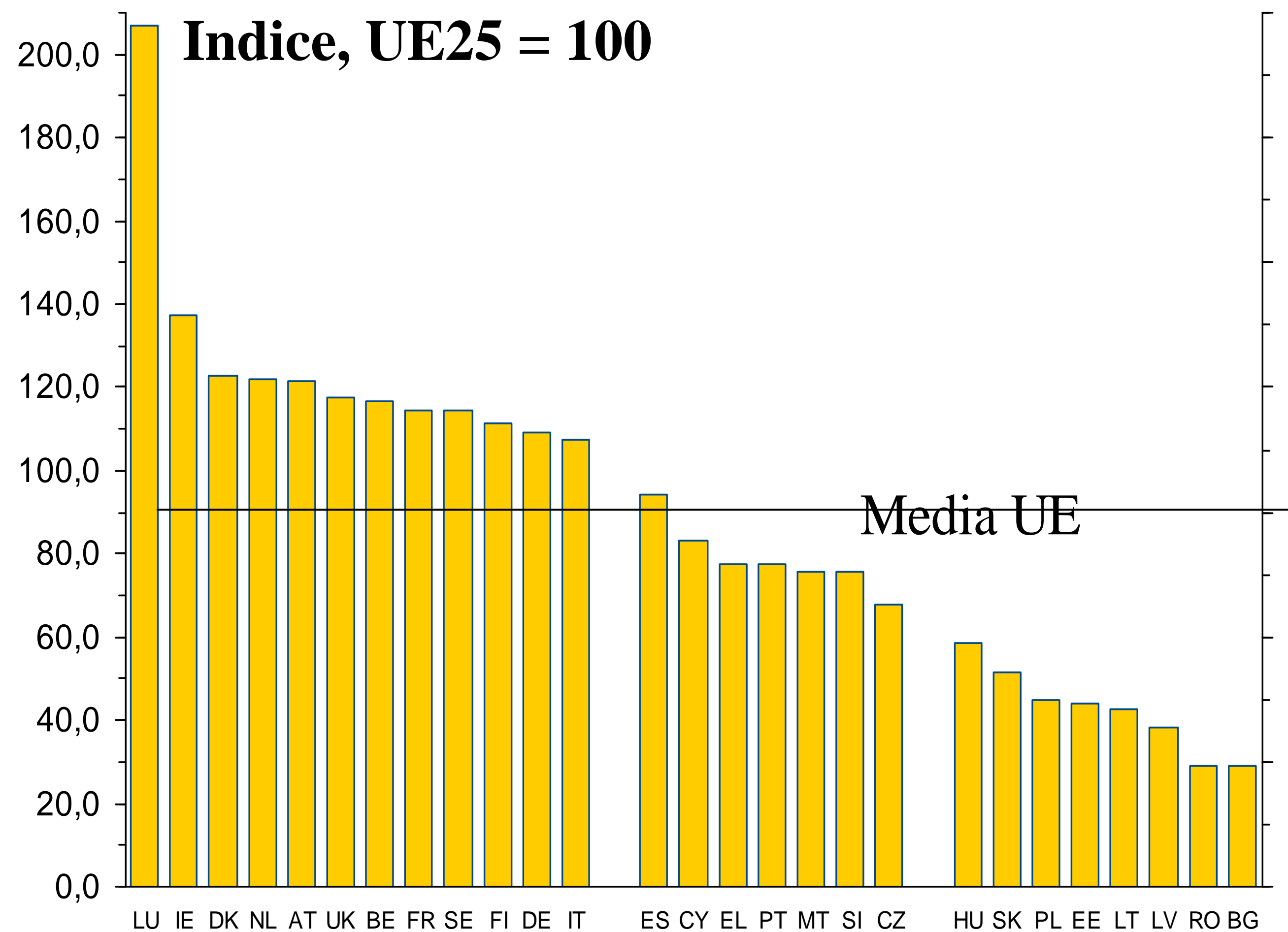
The need of structural reforms

- Economic conditions within EU are very different and have been increasingly so with the enlargement. Thus negative shocks may have very different effects over different countries
- Each country has however less instruments to intervene to support national and local economic conditions and compensate for adverse shocks: monetary policy is defined at EU level, exchange rates are fixed and fiscal policies is constrained by the stability pact and Maastricht rules. There are thus less options to accompany structural reforms with expansive macroeconomic policies at the national level.
- The way to overcome this situation is to increase co-ordination at the EU level both in supporting structural reforms (especially product and labour market reforms) and aggregate demand (via expansionary macroeconomic policies).
- In addition a system of transfer of resources to the lower developed areas of EU is needed in order to reduce development differentials.

However currently:

- The budget for structural and labour market policies is still small (most goes to the Common Agricultural Policy)
- The EC has no political power to make relevant decisions

PIL per abitante



Fonte : Eurostat, National Accounts

Main challenges and future trends

- Stronger competitive pressures (globalisation and enlargement)
- Higher regional differences due to enlargement: in NMS GDP per person is lower, but growth rate higher than in OMS (on average 4% relative to 2,5% of EU15), higher unemployment and share of employment in agriculture, lower wages (4 euros per hour relative to 22); large territorial differentials (urban vs rural)
- Less shock absorbers at national and local level (EMU and euro) and increase in labour mobility and wage moderation.
- Ageing population, which asks for higher participation rates and labour mobility.
- Increasing use of atypical contracts and occupational mobility: more people will have to adapt to job changes during their working life. Need to be able to acquire skills during working life.

Policy implications

The convergence process may be long and costly. There is a need of specific resources and policies to accompany it which operate on the **supply side**.

• policies to support structural reforms in labour and product markets

• policies to sustain labour mobility and to regulate migratory flows

• policies to support convergence in income per-capita

• the necessary control of the budget balance should not jeopardize investments in public infrastructure and social expenditure.

These supply side policies should be coordinated at the EU level.