

Monetary and Fiscal Policy in European Union

Submitted by:

Student no:

Date:

Memorandum of Transmittal

To: Tutor

From: XYZ

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Here I am enclosing the assignment report that discusses about the structure and role of the monetary and fiscal policy in European Union to deal with debt crises. European Union is the combination of its member states that use a common currency. Monetary and fiscal policy of the EU helps the member states to handle the debt crises. Significance of this assignment is that it tells us about the debt crises in Europe. It also helps us to know about monetary and fiscal policy of the European Union and how it deals with the debt crises.

Yours Sincerely,

Executive Summary

European monetary union (EMU) is an economic and monetary union that includes some European member states. It also includes some other states. All member states of EMU use a single currency i.e. Euro. The Maastricht Treaty is a document of EMU that describe some rules for all member states that want to join EMU as it is necessary for them to fulfill the criteria provide by the Maastricht Treaty. Monetary policy in EMU is prepared by the European central bank (ECB). It deals with proper money supply in the country and the main objective of this is to maintain the single currency for EU and price stability in the economy. Maastricht treaty provides a three stage process for establishing a single currency that helps in achieving the main objective of the monetary policy.

Fiscal policy in the EMU is prepared by the government that deals with the government's budget. The government uses the ratio of government consumption to GDP to stabilize fiscal policy. The report also includes some issues related to debt crises in some member states of EMU. These debt crises are found in the member states of EMU for many reasons such as due to excess credit taken by these states and poorly designed mortgages by the institutions. Continuously decline in the savings rates and in the income of people are some other reasons for debt crises in the member states of EMU. Some banks are also engaged in off balance sheet activities and create complex and non transparent products that are not understandable by the banks and the investor effectively.

To solve the debt crisis many reform proposals are prepared By EU such as strengthening the stability and growth pact, interfering with the sovereignty of a country in

crises, a bailout with ex-post condition or based on ex-ante conditions and the foundation of a European monetary fund. Structure of monetary and fiscal policy in the European Union also helps the member states to handle the different economic situations. Like use of a single currency (Euro) helps the member states to minimize the exchange rate risk. The Maastricht Treaty also helps the member state to maintain their credibility according to EMU.

Monetary and fiscal policy of EMU played a great role in handling these crises. Like ECB changes monetary policy to handle the crises such as increase in the inflation rate. These issues are also solved by the proper structured fiscal and monetary policy. A fiscal union is created that deals with debt crises of the member states. In this, the fiscal burden of the weaker states is transferred to the wealthier states. It is beneficial for those member states, whose economic position is worse in the market. The member states whose economic position is good in the market are the losers from this fiscal union. To handle the debt crises, European Union also announced a European Financial Stability Fund (EFSF) that guarantees for national debts.

Due to debt crises in Europe, member countries are unable to raise money from markets at affordable interest rates due to fear over an unsustainable debt and deficit burden. In this situation, only International monetary fund seems a solution of the crises as it provide fund to the weaker states. The IMF is a specialized institution in crises resolution and fiscal stabilization as it provides fund regularly to the affected parties or economies. IMF also promotes European integration because the European Union and the Euro zone countries play a constructive role in providing co-financing to the IMF. This report provides a comprehensive understanding about the debt crisis issue in EMS and role of fiscal and monetary policy.

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Introduction

European monetary union (EMU) is an economic and monetary union among the European states. Other countries also follow this union (Welfens, 1997). Member of EMU includes Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxemburg, Netherlands, Portugal and Spain etc. EMU is an agreement among the members of this union to adopt a single hard currency and a monetary system (Stauffer, 2010). Euro is the single hard currency that is used by the union members. Since January 1, 1999 Euro became the legal currency of EMU. Each member of this union use Euro as a common currency for transactions and other purposes (Stanek, 2001).

Table 1: Macroeconomic differentials in the euro area (deviations from the euro area average)

	Real GDP growth		GDP price deflator	
	1990–1998	1999–2007	1990–1998	1999–2007
euro area	2.1	2.1	3.0	1.9
Belgium	1.9	2.3	2.2	1.8
Germany	2.4	1.5	2.3	0.9
Greece	1.7	4.2	12.2	3.5
Spain	2.5	3.7	4.7	3.8
France	1.8	2.2	1.6	1.6
Ireland	6.6	6.4	2.9	3.6
Italy	1.4	1.4	4.8	2.5
Luxembourg	4.3	5.1	2.3	3.4
Netherlands	2.9	2.1	2.1	2.5
Austria	2.6	2.3	2.1	1.6
Portugal	2.8	1.6	7.0	3.1
Finland	1.2	3.2	2.7	1.2
Standard Deviation ^a	1.5	1.6	3.1	1.0

Source: (Siedschlag, 2008).

The above table shows that the use of a single currency helped the member states to increase their macroeconomic performance as inflation has improved over the period of 1997-2000. The inflation rate and inflation dispersion in the Euro area has declined as they adopted the single currency strategy. Over the period of 1997-2000, some member states experienced positive inflation differential with respect to the Euro area like Greece, Spain, Ireland, Italy, Luxembourg, Netherlands and Portugal. Other member states inflation rates are below the Euro area (Siedschlag, 2008).

Some of EMU members such as Portugal, Ireland, Italy, Greece and Spain are facing debt problems. This paper discusses about the structure and roles of monetary and fiscal policy of the European Union to deal with the debt issue of its member states.

Structure of Monetary and Fiscal Policy in the European Monetary Union

Euro area is considered as an economic area in which the member countries use a single currency instead of their home currency (Edirisuriya, 2010). Some basic principles are provided in the Maastricht Treaty, a document of EMU that describes some rules that help in making sound macroeconomic policies. The monetary policy in EMU is central bank independence and stability oriented and its main objective is to maintain price stability and an obligation for member states to follow the economic policy (Stauffer, 2010).

The Maastricht Treaty is a document that describes the conditions and convergence criteria for each member state who wants to join the EMU. These conditions for EMU membership are necessary because when a state joins the EMU, the domestic economic crises of this state affect all other member states (Kenen, 1995). There are some convergence criteria that a member should follow before joining the EMU. First criteria are that the country

had to reduce its government deficits below 3% of its gross national product. On the other hand, the country had to keep its currency exchange rate with the limit described by EMU etc. To protect monetary policy from profligate fiscal policy, the EU treaty prohibits monetary financing and direct bail outs of governments in financial difficulty (Stauffer, 2010).

Fiscal and Monetary Policy

In EMU, monetary policy is made by central bank, while the fiscal policy is made by the government. The structure or procedure of making the policies can be understand as below -

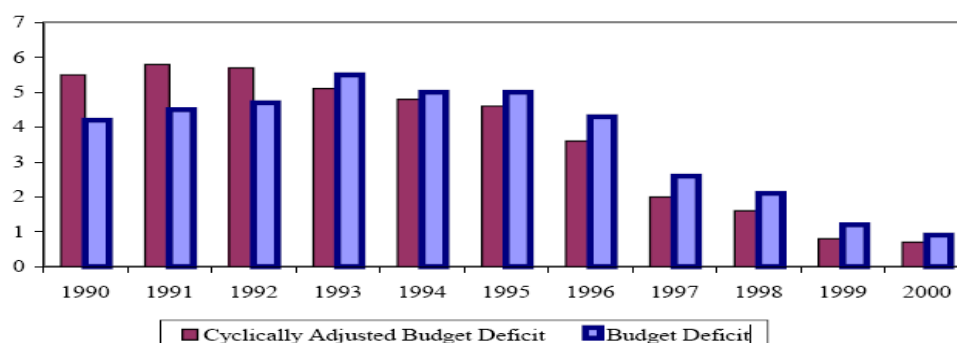
Central bank and Monetary Policy

Monetary policy is designed to manipulate the money supply including bank credit to achieve specified economic objectives by an authorized public authority usually by a central bank (Senn, 1999). The monetary policy in the home economy supports a fixed exchange rate that is acceptable by all member states. Main objective of the monetary policy of EMU is to create a single currency and to ensure that the stability in contrast to price stability and market economy (Pogorelec, 2006).

Treaty provided a three stage process for the establishment of a single currency (Mourmouras & Arghyrou, 2000). First stage began on 1 January, 1990 that described about liberalization of the movement of capital. Second stage provided the suggestions for convergence of economic policies of the member states and this stage commenced on 1 January 1994. Last stage started with the creation of a single currency and the establishment of the central European bank. This stage started from 1 January 1999. In European system, the monetary policy is based on central banks that is a combination of central European bank and the national central bank (Treaty of Maastricht on European Union, 2007).

Government and Fiscal Policy

Fiscal policy in European Union deals with three macroeconomic issues namely stabilizing the problem, coordination the problem and solution of the problem (Kenen, 1995). The government is assumed not be productive and public spending is directed towards final non-tradable goods and it is known as Per Capita Government Consumption. Government finances its consumption through many sources like taxes imposed on consumers, on intermediate sector firms, labor income tax, dividend income tax and seigniorage revenue (Buti, 2003). The government is required to balance its budget in every period. Tax rates are given and calibrated with the EU data. The government uses the ratio of government consumption to GDP as its instrument to pursue stabilizes fiscal policy (Pogorelec, 2006).



Source: (Fatas & Mihov).

The above chart shows the budget deficit and cyclical adjusted budget deficit between the periods of 1990-2000. The cyclical adjusted budget deficit in EU countries moved from 5.9% of GDP in 1991 to 0.7% in 1999. The process of adjustment is uneven as the most adjustments are occurred after the period of 1995. It shows the relationship between government consumption and GDP (Fatas & Mihov).

Structure and Deal with Debt Crisis

Structure of monetary and fiscal policy in the European Union helps the member states to handle the different economic situations. Use of a single currency (Euro) helps the member states to minimize the exchange rate risk. The Maastricht Treaty helps the member state to maintain their credibility according to EMU (Edirisuriya, 2010). EU use monetary policy to counteract sovereign debt crises by reducing the real debt burden through surprise inflation. A member state that is facing a debt crisis is needed a more inflationary monetary policy to reduce the real value of its debt.

European central bank provides a rescue operation in which the interest rates are kept low and monetizing the government debt of the member states (Edirisuriya, 2010). It causes a rise in inflation over the common currency area that helps to reduce the value of debt and to eliminate the issue of debt crisis. This operation of EU is more successful in the condition if all the member states face same level of debt crises (Kuhnhardt, 2008). Thus, monetary and fiscal policy in the European Monetary Union plays a crucial role to handle the debt crises.

Role of Monetary and Fiscal Policy

EMU's member states like Portugal, Italy, Greece, Ireland and Spain are facing some debt crisis issues. They use Euro as a single currency and cannot use their independent monetary policy to solve the problem. Monetary and fiscal policy of EMU plays a crucial role to handle these issues of debt crises in following manner -

Debt Crises in Europe

Debt crises are found in the member states of EMU due to excess credit taken by these states and poorly designed mortgages by the institutions (United Nation Economic and Social

Commission for Western Asia, 2004). The continuous decline in the savings rates and income of people and at the same time a sharp increase in house pricing are the important factors of debt crises in the member states of EMU. Banks are also engaged in off balance sheet activities as they created complex and non transparent products that are not understandable by the banks and the investor effectively (Debt crises in Europe, 2010).

To solve the debt crisis many reform proposals are prepared such as strengthening the stability and growth pact, interfering with the sovereignty of a country in crises, a bailout with ex-post condition or based on ex-ante conditions and the foundation of a European monetary fund (Wyplosz, 2010). All these efforts depend on the Euro zone to solve those problems internally but suffer from the same time-inconsistency problem as the no bail-out clause and the sanction threat of the stability and growth pact. The basis reason for the time-inconsistency problem is the political and culture vulnerability of European integration (Matthes, 2010).

Policy makers see the current debt crisis as self fulfilling and found the problem in itself as crises caused due to staying away of the investors from otherwise worthy assets. The policy makers assumed that new rules preventing disruptive trading practices can restore liquidity, reduce volatility and allow markets to recover that will be effective to handle the debt crisis situation (Edirisuriya, 2010). EU made efforts to address the crisis by preventing devaluation of some sovereign debts and by destructive reprising of assets. European Union and its monetary and fiscal policies played a crucial rule to handle the crisis as some reforms are made both in fiscal and monetary policy (Borensztein, 2004).

Role of Fiscal Policy

A fiscal union is constructed in EMU under the fiscal policy. In this, European Union bailout provided a back stop of the weaker members' sovereign debt by the wealthier countries, effectively shifting the fiscal burden of the weaker states onto the balance sheet of the larger and more stable Euro zone members. The new shared fiscal burden becomes a drag on the ability of the wealthier state to issue debt and access the markets (Basci et al, 2007). With the bailout, the EU provided a formal guarantee for effectively regionalizing the members' debt. It provided benefit to the euro zone members with worse off fiscal indicators especially, Italy, Portugal and Spain. The losers are those members, which are better economic and fiscal fundamentals like Germany, France and Netherlands.

Role of Monetary policy

The European central bank (ECB) changed its monetary policy in two ways by influencing the Greece crisis. First, the ECB has repeatedly adjusted its collateral requirements to ensure that Greece public remained eligible to access debt. The ECB announced on May 3, 2010 its decision to address the crisis that it will suspend the application of the minimum credit rating threshold in the collateral eligibility requirements if marketable debt instruments issued or guaranteed by the Greece government (Leonard, 2010). Second decision was taken on May 10, 2010; in this the ECB announced a series of measures to address the severe tensions in certain market segments, which are hampering the monetary policy transmission mechanism. This includes the announcement of interventions in the Euro area public and private debt securities market to ensure depth and liquidity in those market segments that are dysfunctional (Gerlach, 2010).

The crisis had a large impact on the ECB's policy decision in three ways. First, the weakening of economic sentiment in the euro area caused by the crises has delayed to exit from the ECB's due to very expansionary policy stance. Secondly, the ECB has accepted Greece debt as collateral irrespective of its credit rating and finally ECB has decided to purchase the bond issued by the Greece government and some other borrows to promote the liquidity of the underlying markets (Gerlach, 2010).

European Union announced a European Financial Stability Fund (EFSF) that guarantees national debts. Interest in such a new instrument appears in the midst of the crisis, when the governments discovered that there was no mechanism available to effective bailout for Greece and some other countries. Announcement of EFSF represents a profound change of the Euro area (Stauffer, 2010).

IMF as a one Solution to the Crises

The descent of Greece into sovereign debt crises is the first time that a country, that uses euro, has gone to the IMF. The IMF board approved a 30 euro billion, three year loan for Greece, which complements 80 euro billion being lent to Greece from Euro zone countries. Greece was unable to raise money from markets at affordable interest rates due to fears over an unsustainable debt and deficit burden (Debt crises in Europe, 2010).

To handle the crises IMF is an appropriate solution to take the charge. In the short run, it is appropriate for the Greece crises and a more general institutional reform that help to euro zone country to use the fund in case of imminent default (Sakbani, 2005). Initially this suggestion was put forward by Cologne institute for economic research in March 2009. He supported some arguments that favor the use of IMF to handle the debt crisis (Matthes, 2010).

The IMF is specialized in crises resolution and fiscal stabilization. It provides funds regularly to the affected parties or economies and there is no lack of credibility in the IMF. IMF also promotes European integration because the European Union and the Euro zone countries play a constructive role in providing co-financing to the IMF (Matthes, 2010).

Conclusion

From the above discussion in the report, it can be concluded that the EMU policies are quite effective to facilitate convergence in the member states. The structure of monetary and fiscal policy in EMU is also effective as it is carried on by two different institutions that are effective to manage the undesirable economic situations in the Euro zone. The fiscal and monetary policy structure in EMU area is quite effective to manage the money flow and make the efforts to deal with the debt crisis. The limitations on the member states under the membership documents of EU are also effective to enhance the price and economy stability in the economy. The use of bailout package of IMF is one of the most suitable solutions to eliminate the debt crisis situation.

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Appendices

Appendix 1

Fiscal and monetary policy in the enlarged European Union

In this Pogorelec provides the structure of monetary and fiscal policy in the European Union. Monetary policy is prepared by the European central bank and fiscal policy is prepared by the government. The main objective of monetary policy is to maintain the price stability in the economy.

Pogorelec, S. (2006). *Fiscal and Monetary policy in Enlarged European Union*. European Central

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<http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp655.pdf>.

Appendix 2

The Greece Sovereign debt crises and ECB policy

In this the Gerlach describe the role of monetary policy to handle the Greece crises. This helps the whole European Union to know about the debt crises and manage the crises in the European Union.

Gerlach, S. (2010). *The Greece Sovereign Debt Crises and ECB Policy*. European Parliament.

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