Accession to the European Monetary Union for new EU Members

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ABSTRACT:
In the paper I investigate the consequences of interactions between monetary and fiscal policy for macroeconomic policy in new EU member countries. I use a simple rational expectations general equilibrium model that extends the relevance of the fiscal regime for the price level in an open-economy setting. The model generalizes the framework of Obstfeld and Rogoff (1995) to incorporate the possibility of the "non-Ricardian" fiscal regime. I explicitly specify the dynamic monetary and fiscal policy reaction function. The monetary authority sets nominal interest rates in response to inflation and output gaps. The fiscal authority responds to the outstanding debt by raising taxes.

The accession of new EU members to the European Monetary Union (EMU) requires stabilization of the exchange rate and thus restrictive monetary policy during the transition to a fixed exchange rate. Successful monetary stabilization requires a compatible restrictive fiscal policy.

Keywords: monetary union, monetary policy, monetary feedback, inflation targeting, price level, fiscal regime, fiscal policy
JEL classification: E5, E6, F4