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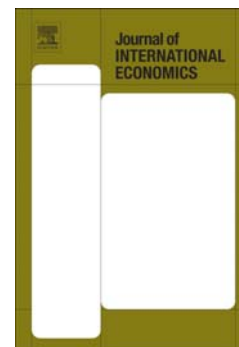
Imbalances and Fiscal Policy in a Monetary Union

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Imbalances and Fiscal Policy in a Monetary Union[☆]Ida Hjortsø¹

Abstract

This paper analyses optimal fiscal policy within a model of a monetary union in which agents cannot perfectly insure themselves against country-specific shocks. I show that optimal cooperative fiscal policies consist in more than just stabilizing output gaps: policy makers can increase welfare by responding to sub-optimal intra-union imbalances. Numerical analysis reveals that if traded goods are little substitutable, optimal cooperative fiscal policies consist in setting government spending in each country so as to reduce intra-union imbalances, potentially at the expense of higher output gaps. Optimal fiscal policies reduce the welfare losses from business cycle fluctuations considerably.

Keywords: Monetary union; International policy cooperation; Optimal monetary and fiscal policies; Risk sharing

JEL codes: F41, F42, E44, E63, E62

1. Introduction

Fiscal policy is an important stabilization tool for countries taking part in a monetary union. Indeed, in the absence of national monetary policy instruments, fiscal policies play a key role in accommodating country-specific shocks. Therefore fiscal policies are at the centre of the theory on optimal currency areas (see e.g. Kenen (1969)) and played a central role in discussions leading up to the creation of the European Economic and Monetary Union (EMU). The debate on the role of fiscal policies was then largely based on a framework in which current account movements resulting from country-specific shocks only had limited effects on welfare. Meanwhile, the euro area crisis has pointed out that sub-optimal current account imbalances can arise within monetary unions in which risk sharing is imperfect, and that reversing these imbalances can prove painful. This paper investigates whether optimal cooperative fiscal policies prevent such intra-union imbalances from arising by leaning against them.

The investigation is based on a two-country DSGE model of a monetary union in which international financial markets are imperfect. As a result, households cannot perfectly insure themselves against country-specific shocks and deviations from perfect risk sharing, i.e. sub-optimal intra-union imbalances, arise. Within this framework, I derive the union-wide welfare-based loss function. It indicates that policy makers can improve union-wide welfare in the face of shocks by reacting not only to sub-optimal movements in

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