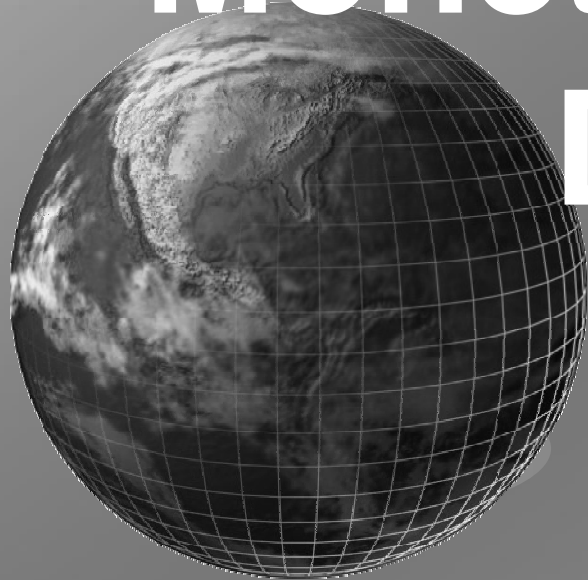


Optimal Fiscal Policy in a Monetary Union: Discussion



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FRBSF, March 4, 2005

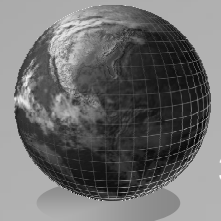
Idea of the Paper

- In a monetary union the central bank can respond only to union-wide macro shocks, not country-specific shocks.
 - This will end up altering optimal fiscal policy.
 - Fiscal policy can mitigate the effects of distortions that monetary policy would otherwise handle.
 - This is shown in a model where lump-sum finance is available and government spending yields utility.
 - Individual countries face two main intervention opportunities: $P > MC$ and monopoly power in trade -- the latter not a global-level distortion.

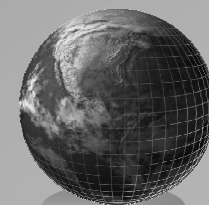


The Model

- Based on a continuum of small open economies, each producing a continuum of differentiated products.
 - A country has a discrete weight $1 - a$ on its own products, so $a = 0$ is a closed economy, $a = 1$ the case of no home bias in consumption.
 - Let x be the utility weight on $\log(G)$. Then for a small open economy with a flexible exchange rate, monetary policy produces the flex-price allocation and $G/Y = x/(1 - a + x)$.
 - In contrast the usual Samuelson optimum is $G/Y = x/(1 + x)$ -- the $a = 0$ case.

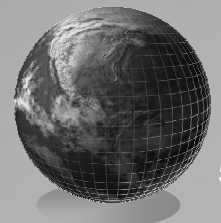


- G is biased toward home goods, so raising it relative to the Samuelson optimum raises the terms of trade, and domestic welfare.
- Reminiscent of the optimum tariff argument.
- Cf. Daniel Gros, “A note on the optimal tariff, retaliation and the welfare loss from tariff wars in a framework with intra-industry trade,” *Journal of Internat. Economics*, November 1987.
- Even for a small country there can be a nonzero optimal tariff with product differentiation.
- Note: Optimal tariff never truly relevant!



Comments

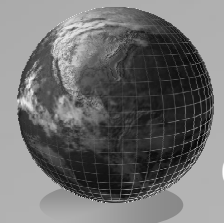
- Any role for fiscal policy requires that G yield private utility -- $x > 0$ needed.
- In non-MU case, a country would never want to distort its TOT by burning output -- except in an immiserizing growth case irrelevant for the assumed trade elasticities.
- In MU case, increasing output simply to burn it is likewise self-defeating.
- But there are other models of fiscal policy.



As the authors note, one would like to add deficits in a meaningful way, as well as distorting taxes.

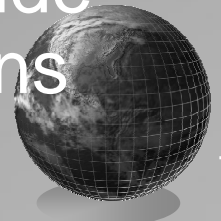
Deficits and have been at the heart of the EMU debate. The Maastricht Treaty seeks to limit deficits to 3% and debts to 60% of GDP. The SPG, pushed by Germany, seeks to enforce these limits.

But these restrictions limit fiscal autonomy in the face of asymmetric national shocks. Enforcement has been lax.



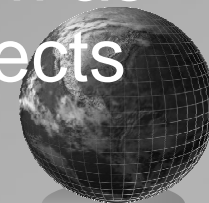
- Of course, much government spending not driven by the cycle.
- Asymmetric shocks are a real problem.
- They are even more of one if, unlike in this model, the union floats against an external world.
- For example, the euro's appreciation against a dollar fixed against the China RMB has disproportionately hurt countries such as Greece that compete more directly with China in world export markets.

Note: the paper states that countries in the MU retain fiscal autonomy, but their solution is for MU-wide welfare -- otherwise optimal tariff considerations creep back in.

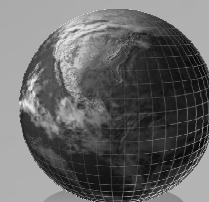


Risk Sharing

- This model contains complete markets for nominal payments -- and thus we have the risk sharing condition from Backus and Smith, *Journal of Internat. Economics*, November 1993.
- For any two (symmetric) countries (regions), $u'(C)/P = u'(C^*)/EP^*$.
- *Implication with log utility*: $c = c^* + (1 - \alpha)s$, where s rising means that (a) our relative export price drops and (b) there is a real currency depreciation.
- Complete markets abstract from one of the biggest problems of monetary unions: fiscal federalism as a risk-sharing device that helps soften the effects of asymmetric shocks.



- In the euro zone there is no automatic redistributive mechanism on a par with those in national currency unions, and the Treaty/SPG are meant to constrain fiscal autonomy. Optimal fiscal policy for a union must consider such redistribution (not allowed in this paper).



Empirics of Risk Sharing

- Backus and Smith rejected the aggregative risk sharing condition empirically.
- Not that international transfers are small. For example, US gross foreign liabilities/GDP = about 1, of which about 95% in US \$.
- US gross foreign assets/GDP = about 0.75, of which about 60% in foreign currencies.
- A 1% balanced dollar depreciation therefore nets the US $(0.75)(0.6)(0.01) - (0.05)(1)(0.01) = 0.4\%$ of GDP, big bucks!
- However, real exchange rate tends to *appreciate* when relative consumption growth is high.



Conceptual Problem with Risk Sharing Condition in Policy Analysis

- We need to be careful in applying a condition such as $c = c^* + (1 - \alpha)s$, even in theoretical models.
- It is not a menu for policy choice.
- It reflects contracting on specific potential future states, which necessarily are uncertain.
- What if the anticipated policy change was not in the set of possible states?
- Then relative consumption growth will not respond according to the risk-sharing condition.
- In general, we need to specify timing of contracts and distribution of policies. But if one policy rule is optimal, it is deterministic and not thus insurable.

