Optimal Fiscal Policy in a Monetary Union: Discussion

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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.
• 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.