NBER WORKING PAPER SERIES

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Working Paper 7607
http://www.nber.org/papers/w7607

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
March 2000

We are grateful to the CNRS and the NSF for financial support. Comments from seminar participants at Boston College, Boston University, the Federal Reserve Bank of Cleveland, the Federal Reserve Bank of Minneapolis, McMaster University, the University of Pittsburgh, the European University Institute (Florence), CREST (INSEE), GREMAQ (Université de Toulouse), GREQAM (Université Aix-Marseille-II), Université de Lyon and EUREQua (Université Paris-1 Panthéon-Sorbonne)are gratefully acknowledged. The views expressed herein are those of the authors and are not necessarily those of the National Bureau of Economic Research.

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JEL No. E50, F33, F41

ABSTRACT

While the European Monetary Union (EMU) is now a reality, debate among economists nonetheless continues about the design and desirability of monetary unions. Since an essential element of a monetary union is the delegation of monetary power to a single centralized entity, one of the key issues in this debate is whether a monetary union will limit the effectiveness of stabilization policy. If so, monetary union will not necessarily be welfare improving.

In this paper, we study a two-country world economy and consider various designs of monetary union. We argue that the success of monetary union depends on : (i) the commitment ability of the single central bank, (ii) the policy flexibility of the national fiscal authorities and the central monetary authority and (iii) the cross country correlation of shocks. If, for example, the central bank moves before the fiscal authorities, then a monetary union will increase welfare as long as fiscal policy is sufficiently responsive to shocks. However, if the fiscal authorities have a restricted set of tools and/or the monetary authority lacks the ability to commit to its policy, then monetary union may not be desirable.

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1 Overview

While the European Monetary Union (EMU) is now a reality, the debate nonetheless continues about the desirability and design of monetary unions. Many countries, such as Argentina, are considering the dollarization of their economy as a possible policy. Further, some economists are advocating the creation of a North American Monetary Union.[1]

The framework for these discussions essentially remains that outlined by Mundell [1961]: the gains to monetary union arise from eliminating barriers to transactions while the costs reflect the reduced effectiveness of stabilization policy once monetary policy is delegated to a single central bank.[2] In his evaluation of the EMU, Feldstein [1997] perfectly exemplifies the dilemma about the evaluation of a monetary union when he writes:

> "My own judgement is that, on balance, a European Monetary Union would be an economic liability. The gains from reduced transaction costs would be small and might, when looked at from the global point of view, be negative. At the same time, EMU would increase cyclical instability, raising the cyclical unemployment rate".

While certainly relevant in some aspects, this framework misses an important element: the design of monetary union. Clearly there is more to monetary union than the adoption of a single currency. The success of any monetary union, in particular the EMU, will depend in large part on the appropriate design of monetary policy, including its interaction with national fiscal policies.[3] Existing (and defunct) monetary unions have experienced very different macroeconomic performances, particularly with regard to the stabilization of output and inflation. We contend that the issues of stabilization policy and design of a monetary union are closely interrelated: the stability of member economies within a monetary union

[1] On North American Monetary Union, see Buiter [1999], Grubel [1999] and the references therein.

[2] These issues are paramount in the so-called Delors report (Emerson et al., [1992]) which provided the official arguments in favor of EMU. These same points reappear in the analysis of the proposed North American Monetary Union as discussed by Buiter [1999].

[3] Designers of monetary unions have been cognizant of these issues. For the EMU, the Maastricht treaty contains several clauses specifying in detail the institutional set-up of the EMU. The European system of Central Banks, including the European Central Bank, is strongly independent of any government; its prime objective is price stability; the ECB cannot bail-out any fiscal authority. Further, the Amsterdam Treaty contains a "Growth and Stability Pact" which, in effect, strongly constrains the ability of member countries to run fiscal deficits. A detailed system of punishments has been established in the event a country incurs a deficit which is "excessive" in light of current economic conditions.

depends on the manner in which the stabilization instruments are allocated. Thus the trade-off, as framed by Mundell, misses this crucial dimension.

In the debate over monetary union, a number of interrelated questions naturally emerge. First, when is it in the interest of a set of countries or regions to share a common currency and to delegate monetary policy to a single central bank? Second, how should the monetary authority operate vis-a-vis the independent fiscal authorities, either national or regional? Third, can this monetary/fiscal system adequately respond to shocks? Under what conditions will stabilization policy be effective in a monetary union?

We address these questions using a multiple country, overlapping generations model.[4] The model has two key ingredients: *(i)* the presence of country specific shocks which generate a basis for stabilization policy and *(ii)* strategic interaction between the multiple fiscal authorities and the single monetary authority. Thus our approach is quite different from Mundell [1961] which rested on price inflexibility in a static economy without any explicit representation of welfare and without any recognition of the vital importance of the interactions between fiscal and monetary policy.

We find that if the monetary authority has the ability to move prior to the fiscal authorities, then it is able to select a monetary policy that will support the first-best allocation of risk. In this case, monetary union creates benefits of reduced transactions costs without jeopardizing stabilization policy: the supposed trade-off does not exist and monetary union is welfare improving.

We explore two alternative, less successful, designs of monetary union. In one, some policymakers, either the fiscal or monetary authorities, are unable to adequately respond to economic events. These types of restrictions, in effect, limit the scope for successful stabilization and thus create a cost to monetary union. For the second, the central monetary authority does not have the ability to credibly commit to its policy. This *weak* central bank responds to the budget decisions of the independent fiscal authorities. As a consequence, each member country forces money creation by the central bank as a means of financing its fiscal deficit. In these cases, a monetary union can reduce welfare relative to a world economy with multiple currencies.

[4]The model adds uncertainty and interaction between fiscal and monetary authorities to the framework in Cooper-Kempf [1998].

2 First-Best Allocation

This section of the paper presents our model of the world economy and solves for the first-best allocation. This forms a benchmark to which we can compare the allocations obtained by different monetary/fiscal systems.

2.1 Basic Environment

All agents live for two periods and reside in one of two countries. By assumption, labor is immobile.[5] In each country, a single, nonstorable good is produced. Agents work in youth, producing the country specific good and consume the goods produced in both countries in their old age.

Agents differ within countries due to their employment status: each period a random fraction q_t of them have an employment opportunity while the remainder are unable to produce.[6] This device allows us to include real shocks to the model and motivates government intervention through the provision of unemployment insurance.[7] We assume that q_t is a serially uncorrelated shock with $E[q_t] = \bar{q} \epsilon (0,1)$.

With regard to their preferences, agents consume the good produced at home and the one produced abroad. As in Cooper-Kempf [1998], we introduce individual specific shocks into preferences to motivate the gains from monetary union. More formally, individuals in the home country have preferences represented by the following utility function:

$$U^{ih} = U\left(c_{t+1}^{ih}, c_{t+1}^{if}, n_t^i\right) = \theta_{t+1} \ln\left(c_{t+1}^{ih}\right) + (1-\theta_{t+1}) \ln\left(c_{t+1}^{if}\right) - g\left(n_t^i\right). \tag{1}$$

The superscript i corresponds to the status of the agent, whether she is employed ($i = E$) or unemployed ($i = U$), c_{t+1}^{ih} is the level of consumption of the home good when old, and c_{t+1}^{if} is the level of consumption of the foreign good when old, and n_t^i is the supply of labor by agent i, necessarily equal to zero if $i = U$. The function $g(\cdot)$ represents the disutility of

[5] Thus, relative to the discussion in Mundell [1961], our results are biased against finding gains to monetary union.

[6] Here and throughout the paper, we generally refer directly to home country variables and denote those for the foreign country with * superscripts.

[7] Clearly this is just one of a multitude of possible shocks. This specification was chosen partly for tractability and partly due to the fiscal obligation that arises from the provision of unemployment insurance, a natural and quite visible form of stabilization policy.

work, and is assumed to be increasing, convex and continuously differentiable. Finally, θ_{t+1} is an individual specific taste shock that influences the marginal rate of substitution between home and foreign goods, where θ_{t+1} is an i.i.d random variable with mean $\overline{\theta}$. Given the specification of the utility function, it is natural to restrict $\theta_{t+1}\epsilon[0,1]$. This shock is realized in period $t+1$, after the labor supply decision.

The production function is the identity function and there is no capital. As agents are identical at the time of their labor supply decision, they will work the same amount, denoted as n_t. Hence per capita output of the home good in period t is simply $n_t q_t$. Throughout the paper, unless specifically noted otherwise, there are analogous expressions for the foreign country.

2.2 Planner's Problem

The planner's objective is to maximize a weighted average of the welfare of the agents in each generation and in each country. As the countries are completely symmetric, the planner gives equal weight to them.[8] Further, we assume that the planner treats each generation equally. Since there is no physical capital and preferences are intertemporally separable, we look at allocations within a period where the planner decides on the employment levels of generation t agents and the consumption levels for generation $t-1$ agents. In doing so, the planner is assumed to know the current state of the economy, including the realized tastes for each agent and the employment rates in the two countries. Put differently, the planner chooses state contingent consumption allocations for old agents and employment levels for young agents where the aggregate state is denoted by $s = (q_{-1}, q^*_{-1}, q, q^*)$ and θ (θ^*) represents the realization of the taste shock for an arbitrary home (foreign) agent.[9]

Formally, at the start of any period, the planner selects a contingent consumption profile for home and foreign old agents given by:

$$c(s,\theta) = (c^{Eh}(s,\theta), c^{Ef}(s,\theta), c^{Uh}(s,\theta), c^{Uf}(s,\theta))$$

$$c^*(s,\theta^*) = (c^{*Eh}(s,\theta^*), c^{*Ef}(s,\theta^*), c^{*Uh}(s,\theta^*), c^{*Uf}(s,\theta^*))$$

[8]Thus the model abstracts from any political considerations that might lead to unequal treatment of countries and/or generations.

[9]Here q (q^*) denotes a current value and q_{-1} (q^*_{-1}) the past value. In principle, the planner could make consumption dependent on past employment status as well.

respectively. Further, the planner chooses $(n(s), n^*(s))$, the state contingent employment levels of the current generation. Note that these functions are not time dependent as we focus on stationary solutions.

The planner solves

$$\max_{c(s,\theta),c^*(s,\theta^*),n(s),n^*(s)} E_{(s,\theta,\theta^*)}\{q_{-1}U^{Eh} + (1-q_{-1})U^{Uh} + q^*_{-1}U^{*Eh} + (1-q^*_{-1})U^{*Uh}$$

$$-qg(n(s)) - q^*g(n^*(s))\} \tag{2}$$

subject to:

$$E_{\theta,\theta^*}[q_{-1}c^{Eh}(s,\theta) + (1-q_{-1})c^{Uh}(s,\theta) + q^*_{-1}c^{*Eh}(s,\theta^*) + (1-q^*_{-1})c^{*Uh}(s,\theta^*)] = n(s)q \tag{3}$$

$$E_{\theta,\theta^*}[q_{-1}c^{Ef}(s,\theta) + (1-q_{-1})c^{Uf}(s,\theta) + q^*_{-1}c^{*Ef}(s,\theta^*) + (1-q^*_{-1})c^{*Uf}(s,\theta^*)] = n^*(s)q^* \tag{4}$$

for all s.

The resulting allocation has two important aspects: optimal risk sharing across agents and an efficient level of employment. Formally:

Proposition 1 *The first-best allocation is characterized by:*

$$\frac{\theta}{c^{Eh}(s,\theta)} = \frac{\theta}{c^{Uh}(s,\theta)} = \frac{1-\theta^*}{c^{*Eh}(s,\theta^*)} = \frac{1-\theta^*}{c^{*Uh}(s,\theta^*)} \tag{5}$$

$$\frac{1-\theta}{c^{Ef}(s,\theta)} = \frac{1-\theta}{c^{Uf}(s,\theta)} = \frac{\theta^*}{c^{*Ef}(s,\theta^*)} = \frac{\theta^*}{c^{*Uf}(s,\theta^*)} \tag{6}$$

and

$$g'(n)nq = 1 = g'(n^*)n^*q^*. \tag{7}$$

Proof. See appendix. ■

From this proposition, the planner allocates the given amount of the two consumption goods across the agents so that the ratio of marginal utilities of consumption between any two agents is state independent. This is the familiar expression of optimal risk sharing. For our economy this implies that any two agents with the same realization of tastes should consume identical consumption bundles independent of nationality or employment status. For the employment decision, recall that young agents do not know their tastes. Thus for the planner, the employment levels may only depend on (q, q^*).

3 A Multi-Currency World Economy

We now consider decentralized environments. Our starting point is a multiple currency world economy in which both fiscal and monetary policies are determined by national governments. A key issue is the financing of obligations to the unemployed and risk sharing across countries since this is the essence of "stabilization policy" in our environment.

This section presents a baseline model of a two-country world economy in which the governments in each of the two countries independently choose their fiscal and monetary policies. In order to capture potential gains to monetary union from a reduction in trading frictions, there is an incomplete markets feature in our model. In each period, goods markets open **before** exchange markets. Thus, old agents are unable to adjust their currency portfolios in response to taste shocks. As we shall see, this leads to a misallocation of resources.[10]

3.1 Individual Optimization

The agent's decisions over employment and consumption goods are constrained by her income and by cash-in-advance constraints as both goods must be purchased in the corresponding currency.[11] We show these constraints in detail for an agent in the home country. Let I_t^i represent the income of a home agent of generation t with employment status $i = E, U$. Further, let m_t^{ih} and m_t^{if} represent the holdings of home and foreign currency by a home agent of generation t with employment status $i = E, U$. The constraints of a home agent are then given by:

$$m_t^{ih} + e_t m_t^{if} = I_t^i \tag{8}$$

and:

$$p_{t+1} c_{t+1}^{ih} = m_t^{ih} \qquad p_{t+1}^* c_{t+1}^{if} = m_t^{if} \tag{9}$$

for $i = E, U$. According to (8), income earned in youth is held either as home currency or foreign currency, where e_t is the period t price of foreign currency in terms of home currency.

[10] Clearly the assumed timing of markets is key to our results. In our framework, the cost of going to an exchange market for old agents is thus infinite. As we shall see, the implications of this infinite cost can be parameterized by the uncertainty over tastes.

[11] Cooper-Kempf [1998] argue that the cash-in-advance constraints can be generated endogenously by allowing individual governments to choose over legal restrictions regarding the type of currency used in their home markets. Here, for tractability, we impose these constraints directly. Notable contributions by Lucas [1990], Fuerst [1992] and Christiano and Eichenbaum [1992] also use a particular sequencing of exchanges to limit transactions through the introduction of costly market participation.

Equations (9) relate the holdings of the different currencies to the consumption of final goods and thus reflect the cash-in-advance constraints.

Given income levels, the consumption levels of the individual agents are:

$$c_{t+1}^{ih} = \frac{\bar{\theta} I_t^i}{p_{t+1}} \qquad \text{and} \qquad c_{t+1}^{if} = \frac{(1-\bar{\theta}) I_t^i}{p_{t+1}^*} \tag{10}$$

for $i = E, U$. In contrast to the planner's solution, consumption is independent of the realized taste shock. It is in this sense that multiple currencies lead to the misallocation of resources and thus a gain from monetary union.

Governments are assumed to levy taxes on labor incomes, where τ_t^F denotes the period t tax rate. Thus the income of a representative employed agent is given by:

$$I_t^E = p_t n_t \left(1 - \tau_t^F\right). \tag{11}$$

Using this definition of income, the first order condition with respect to employment by a representative generation t agent is:[12]

$$1 = n_t g'(n_t). \tag{12}$$

So, for Cobb-Douglas utility functions, individual labor supply decisions are independent of the proportional labor income tax. Denote by $\bar{n}$ this input.

The income of a representative unemployed agent is given by:

$$I_t^U = b_t^F \tag{13}$$

where b_t^F is the nominal unemployment benefit paid to an unemployed agent. These transfers are financed from the tax revenues collected from the employed agents and the printing of new currency as described further below.

[12]The derivation of this expression is part of the proof of Proposition 2.

3.2 Market Equilibrium Given Government Policies

In each period, a goods market and a money market open in each of the two countries. The market clearing conditions for the good markets, home and abroad respectively, in period $t+1$ are:

$$q_{t+1}\bar{n} = q_t c_{t+1}^{Eh} + (1-q_t)\, c_{t+1}^{Uh} + q_t^* c_{t+1}^{*Eh} + (1-q_t^*)\, c_{t+1}^{*Uh} \tag{14}$$

$$q_{t+1}^*\bar{n} = q_t^* c_{t+1}^{*Ef} + (1-q_t^*)\, c_{t+1}^{*Uf} + q_t c_{t+1}^{Ef} + (1-q_t)\, c_{t+1}^{Uf} \tag{15}$$

The left side of these expressions is the output by employed agents in period $t+1$, using the fact that all employed agents produce $\bar{n}$ units of output. The right side corresponds to spending on home (foreign) goods by the four types of agents: employed and unemployed in each of the two countries.

For the money markets, the given stock of fiat money must equal the nominal value of output. For the home and foreign countries this implies:

$$M_t = p_t q_t \bar{n} \tag{16}$$

$$M_t^* = p_t^* q_t^* \bar{n}. \tag{17}$$

The exchange market clearing condition is simply:

$$q_t^* m_t^{*Eh} + (1-q_t^*) m_t^{*Uh} = e_t (q_t m_t^{Ef} + (1-q_t) m_t^{Uf}). \tag{18}$$

Finally, the governments each face a budget constraint. The transfers to the unemployed must be financed by either the collection of tax revenues or the printing of money, denoted Δ_t^F. Thus, for the home country,

$$p_t q_t \tau_t^F \bar{n} + \Delta_t^F = (1-q_t) b_t^F. \tag{19}$$

These transfers to agents occur prior to exchange market trades. Thus, unemployed agents are unable to consume foreign goods.

The allocation given government policies is then characterized by:

Proposition 2 *In a world economy with multiple currencies, given government transfer*

policies the (home) consumption allocations are given by:

$$c_{t+1}^{Eh} = \overline{\theta} \cdot \frac{q_{t+1}}{q_t} \cdot \frac{1-\tau_t^F}{1+\sigma_t} \cdot \overline{n}, \quad c_{t+1}^{Ef} = \left(1-\overline{\theta}\right) \cdot \frac{q_{t+1}^*}{q_t} \cdot \frac{1-\tau_t^F}{1+\sigma_t} \cdot \overline{n}, \tag{20}$$

$$c_{t+1}^{Uh} = \overline{\theta} \cdot \frac{q_{t+1}}{1-q_t} \left(1 - \frac{1-\tau_t^F}{1+\sigma_t}\right) \overline{n}, \quad c_{t+1}^{Uf} = \left(1-\overline{\theta}\right) \cdot \frac{q_{t+1}^*}{q_t} \left(1 - \frac{1-\tau_t^F}{1+\sigma_t}\right) \overline{n}. \tag{21}$$

Proof. See appendix. ■

In these expressions, the rate of growth of the money supply is denoted by σ_t^F and is computed directly from the transfers. That is, $\sigma_t^F M_t = \Delta_t^F \equiv M_t - M_{t-1}$ and $\sigma_t^{*F} M_t^* = \Delta_t^{*F} \equiv M_t^* - M_{t-1}^*$.

Clearly home consumption (and foreign as well) will depend on the shocks to employment during the agents lifetime in both countries. Thus insurance must be provided to offset these various disturbances. From these conditions, it is also apparent that the fiscal and monetary policies interact in a particular way: consumptions are determined by the ratio $(\frac{1-\tau_t^F}{1+\sigma_t})$ indicating that income taxes and inflation taxes operate in a similar fashion in our economy.

3.3 Equilibrium Government Policies

Without loss of generality, the fiscal and monetary authorities within each country are integrated. However, governments act non-cooperatively vis-a-vis one another. Their objective is to maximize the expected lifetime utility of a representative young agent in their own country. They choose tax rates and money creation rates simultaneously each period, after observing the fraction of people currently employed and taking as given the policy choices of the other government.[13]

The equilibrium of the non-cooperative game is characterized by:

Proposition 3 *In a world economy with flexible exchange rates and multiple currencies, the*

[13]Note that the money supplies in each country are the only state variables in the system as there is no physical capital. In addition, policy choices can be contingent on the realized values of the employment shocks in the two countries. The equilibria that we characterize are dependent only on the country specific employment rates and are Markov perfect given this representation of the state space. Note that these restrictions seem natural given that the inherited stocks of fiat money in each country are, in the equilibria we consider, irrelevant for real allocations. Of course, there may exist other equilibria in which inherited money stocks matter.

equilibrium policies satisfy:

$$\xi_t \equiv \frac{1-\tau_t^F}{1+\sigma_t^F} = q_t, \ \xi_t^* \equiv \frac{1-\tau_t^{*F}}{1+\sigma_t^{*F}} = q_t^*. \tag{22}$$

Proof. See appendix. ■

In this expression, ξ_t represents the period t policy choice of the home government. This policy reflects the rate of labor taxation and the rate of money creation. In equilibrium the governments are indifferent with respect to the nature of the taxation: the optimal policy is characterized by combinations of the labor tax and the inflation tax that transfer a given amount to the unemployed. This indeterminacy, reminiscent of the Tinbergen rule, simply reflects the existence of two instruments at the disposal of governments when each government only has a goal: to insure agents against the risk of unemployment.

Using the optimal tax policies, equilibrium consumption allocations are:

$$c_{t+1}^{Eh} = c_{t+1}^{Uh} = \overline{\theta} q_{t+1} \overline{n} \qquad \text{and} \qquad c_{t+1}^{Ef} = c_{t+1}^{Uf} = \left(1-\overline{\theta}\right) q_{t+1}^* \overline{n} \tag{23}$$

and

$$c_{t+1}^{*Eh} = c_{t+1}^{*Uh} = (1-\overline{\theta}) q_{t+1} \overline{n} \qquad \text{and} \qquad c_{t+1}^{*Ef} = c_{t+1}^{*Uf} = \overline{\theta} q_{t+1}^* \overline{n}. \tag{24}$$

Note that the optimal non-cooperative government policies perfectly insure agents from the current risk of unemployment. Further, the flexible exchange rate system implies that consumptions are equalized across countries as well. In this sense, the multiple currency equilibrium with optimal government policies provides insurance both within and across countries.

However, there are some important differences between this allocation and that obtained by the planner. First, the labor supply of the home (foreign) agents is independent of q (q^*) as the Cobb-Douglas preferences imply that this decision is independent of the tax rate. In the planner's solution, employment varies with q (q^*) in order to stabilize total output.[14] Second, contrary to the planner's solution, agents suffer from their inability to have consumption depend on the realized taste shocks.

Using the expressions for consumption allocations, the expected utility (welfare) gener-

[14]Interestingly, this optimal employment policy would arise if the government had access to lump-sum taxes.

ated by this equilibrium is equal to:

$$\begin{aligned} V_F &\equiv E\left[q_t U\left(c_{t+1}^{Eh}, c_{t+1}^{Ef}, \overline{n}\right) + (1-q_t)\, U\left(c_{t+1}^{Uh}, c_{t+1}^{Uf}\right)\right] \\ &= E\left(\theta_{t+1} \ln\left(\overline{\theta}\right) + (1-\theta_{t+1}) \ln\left(1-\overline{\theta}\right)\right) \\ &\quad + \overline{\theta} E \ln\left(q_{t+1}\right) + \left(1-\overline{\theta}\right) E \ln\left(q_{t+1}^{*}\right) + \ln(\bar{n}) - \bar{q} g(\bar{n}). \end{aligned} \tag{25}$$

This measure is used as the benchmark relative to which the various designs of a monetary union will be compared and assessed.

4 Strong Central Bank

We now consider a monetary union defined by the presence of a single currency and a **single** monetary authority which represents the interests of agents in member countries.[15] In this section, we make a key assumption regarding timing: the central bank chooses its policy **before** the fiscal authorities in each period. We term this a **strong** central bank since the timing assumption implies that the monetary authority has commitment power vis-a-vis fiscal authorities. The next section of the paper explores the alternative case in which the central bank moves after the fiscal authorities.[16]

4.1 Individual Optimization

In contrast to the world economy with multiple currencies, agents do not have to make portfolio decisions prior to the realization of their taste shocks. It is precisely the relaxation of the cash-in-advance constraints that leads to the gains associated with monetary union. Formally, the representative young, employed agent of generation t from the home country solves the following optimization problem:

$$\max_{c_{t+1}^{Eh}, c_{t+1}^{Ef}, n_t} E\{\theta_{t+1} \ln\left(c_{t+1}^{Eh}\right) + (1-\theta_{t+1}) \ln\left(c_{t+1}^{Ef}\right)\} - g\left(n_t\right) \tag{26}$$

[15] To maintain symmetry, we assume that this stock of money is initially distributed equally across the two countries.

[16] Interestingly, this parallels the discussion of Sargent and Wallace [1981] who analyze closed economy monetary models with two polar forms of coordination between the fiscal and monetary authorities.

subject to

$$p_{t+1}c_{t+1}^{Eh} + p_{t+1}^{*}c_{t+1}^{Ef} = p_t n_t(1-\tau_t^S) \equiv I_t^E. \tag{27}$$

Here the tax rate on the income of the home agent is given by τ_t^S. In the budget constraint, p_t (p_t^*) represents the period t price of home (foreign) goods in terms of the common currency.

The first order conditions for the representative, employed home agent are given by:

$$g'(n_t)n_t = 1 \tag{28}$$

and

$$c_{t+1}^{Eh} = \theta_{t+1}\frac{I_t^E}{p_{t+1}} \qquad \text{and} \qquad c_{t+1}^{Ef} = (1-\theta_{t+1})\frac{I_t^E}{p_{t+1}^*}. \tag{29}$$

(28) implies a constant labor supply equal to that obtained in the previous case, $\bar{n}$. Thus, with these Cobb-Douglas preferences over goods, the monetary institution has no effect on employment decisions. Since the consumption decision is made after the realization of the taste shock, consumption levels respond to this shock.

Optimal consumption levels for the representative unemployed agent satisfy:

$$c_{t+1}^{Uh} = \theta_{t+1}\frac{I_t^U}{p_{t+1}} \qquad \text{and} \qquad c_{t+1}^{Uf} = (1-\theta_{t+1})\frac{I_t^U}{p_{t+1}^*}. \tag{30}$$

Since these agents are unemployed, their nominal income is equal to the unemployment benefits they receive both from their national fiscal authority, denoted by b_t^S.

The fiscal policies are given by the levels of labor taxation and unemployment benefits, (τ_t^S, b_t^S) for the home government and (τ_t^{*S}, b_t^{*S}) for the foreign government. The central monetary authority creates money in period t which is distributed to the fiscal authorities of the two governments. We let Δ_t^S and Δ_t^{*S} denote the period t money transfers to the home and foreign governments.

So, the budget constraint of the home fiscal authority is given by:

$$(1-q_t)b_t^S = \tau_t^S \bar{n} p_t q_t + \Delta_t^S. \tag{31}$$

The left side of this expression is the level of unemployment benefits paid by the home government. The right side is the sum of their nominal tax revenues and the money created that flows to the home government.

4.2 Equilibrium

This institutional structure corresponds to a two-stage game, where the central bank plays first and decides upon transfers to the national governments. The fiscal authorities of the two national governments play second, non-cooperatively determining their own policy. From (31), the money transfers simply supplement the resources available for the funding of unemployment insurance.

The following proposition characterizes the equilibrium of this game. In the second stage, the fiscal authorities, given transfers from the monetary authority, will design UI systems that equate the incomes of employed and unemployed agents, as in the regime of multiple currencies. Taking these decision rules by the fiscal authorities as given, the monetary authority can use money creation to finance these UI programs and thus redistribute nominal incomes across countries to offset adverse employment shocks. However, in equilibrium, the response of prices to variations in the employment shocks is sufficient for the stabilization of nominal income: active intervention by the central monetary authority is not required. Thus we find:

Proposition 4 *There exists an equilibrium in the strong monetary union where the rate of money creation is zero, irrespective of the values of the shocks, the taxation rates are equal to*

$$\tau_t^S = 1 - q_t \qquad \tau_t^{*S} = 1 - q_t^*. \tag{32}$$

The consumption allocations are given by:

$$c_{t+1}^{Eh} = c_{t+1}^{Uh} = \theta_{t+1} q_{t+1} \overline{n} \qquad \text{and} \qquad c_{t+1}^{Ef} = c_{t+1}^{Uf} = (1 - \theta_{t+1})\, q_{t+1}^* \overline{n} \tag{33}$$

$$c_{t+1}^{*Eh} = c_{t+1}^{*Uh} = (1 - \theta_{t+1}) q_{t+1} \overline{n} \qquad \text{and} \qquad c_{t+1}^{*Ef} = c_{t+1}^{*Uf} = \theta_{t+1} q_{t+1}^* \overline{n} \tag{34}$$

and the employment allocations satisfy $n = n^* = \overline{n}$ where:

$$g'(\overline{n})\overline{n} = 1.$$

Proof. See appendix. ■

Note that the consumption levels for each type of agent depend on the *ex post* realization of the individual specific taste shock θ. This dependence of consumption on θ, as in the

planner's allocation, is surely one of the gains associated with having a common currency.

A very important aspect of the resulting allocation is that agents' nominal income levels are independent of both their individual employment status and against country specific shocks to employment rates (q_t,q_t^*) in their youth. The first form of insurance is provided directly by the taxation policy of the fiscal authorities, as in the above proposition. Recall from Proposition 2 that in the economy with independent fiscal and monetary policies, the authorities were indifferent between financing UI benefits with labor income taxes or seignorage. Essentially, the strong monetary union removes one of the two tools so that the fiscal authorities are led to the use of labor income taxes to finance the country specific UI systems.[17]

The second form of insurance is provided by the stabilization of nominal incomes in response to the supply side employment shocks. Given the unitary elasticity of demand, created by the Cobb-Douglas preference structure, variations in prices effectively offset the exogenous variations in employment rates leaving the nominal income earned by young employed agents independent of q_t.[18] If, as we assume, the money supply is equally distributed across the two countries in the initial period, then the young agents in each country will have equal shares of the money supply in all time periods. This guarantees that their nominal incomes are stabilized in the equilibrium with zero money growth.

There are other equilibria under strong monetary union. From Proposition 2, it is apparent that consumption allocations depend jointly on the rate of income taxation and the rate of money creation. The allocation in Proposition 4 picks one such combination of policies. In particular, if the lower support of the country specific employment shocks is sufficiently large, there will exist equilibria with positive money creation along with positive state contingent income taxes. To guarantee that nominal incomes are equal across countries, the nominal transfers to each country will be identical. Importantly, all of these equilibria support the same real allocations of consumption and employment.

[17]Thus one might conjecture that an important element in this discussion of stabilization with strong monetary union has to do with the number of instruments relative to targets. In our economy, a single government has two instruments to hit a target. Hence, as demonstrated in Proposition 2, there is an indeterminacy with respect to the nature of intervention. So, monetary union is not destabilizing here because even in the absence of active monetary intervention, the fiscal powers are sufficient. We return to this issue of instruments vs. targets in Section 5.

[18]cf. Cole and Obstfeld [1991].

In this equilibrium the welfare of the representative agent is:

$$\begin{aligned} V_S &= E\left\{\theta_{t+1}\ln\left(\theta_{t+1}\right)+\left(1-\theta_{t+1}\right)\ln\left(1-\theta_{t+1}\right)\right\} \\ &\quad +\overline{\theta}E\ln\left(q_{t+1}\right)+\left(1-\overline{\theta}\right)E\ln\left(q_{t+1}^{*}\right)+\ln\left(\overline{n}\right)-\overline{q}g(\overline{n}). \end{aligned} \tag{35}$$

Here the expectation is taken with respect to the individual specific taste shock θ_{t+1} and to the employment shocks during the agent's lifetime $(q_t, q_{t+1}, q_{t+1}^{*})$.

4.3 Welfare Comparisons

This expression of welfare allows us to compare the allocation under a strong central bank with that obtained by a world economy with multiple currencies.

Proposition 5 *The difference in expected utilities achieved under a strong central bank and a flexible exchange rate world economy with multiple currencies is always positive and equal to:*

$$\begin{aligned} \Lambda_{SF} &\equiv V_S - V_F = E\left\{\theta_{t+1}\ln\left(\frac{\theta_{t+1}}{\overline{\theta}}\right)+\left(1-\theta_{t+1}\right)\ln\left(\frac{1-\theta_{t+1}}{1-\overline{\theta}}\right)\right\} \\ &\simeq 1/2 * var(\theta)[\frac{1}{\overline{\theta}}+\frac{1}{(1-\overline{\theta})}]. \end{aligned} \tag{36}$$

Proof. See appendix. ■

Clearly the gain to monetary union comes from the ability of agents' to response to the realization of their taste shocks. Analytically, this gain is reflected in the $var(\theta)$ term in Λ_{SF}: increases in the variability of the taste shocks will reduce V_F and thus increase Λ_{SF}. Further, the reduction in the number of stabilization tools in each country (due to the creation of a central monetary authority) does **not** limit the extent to which agents are insured against aggregate shocks. Essentially, the fiscal authorities can respond to country specific unemployment shocks and thus efficiently insure the incomes of agents against employment risk. The risk associated with unemployment variations is dissipated in the goods markets.[19] So in contrast to the predictions arising from the work of Mundell, there is no tradeoff

[19]This is clearly a strong result that, as we shall see, depends on the unitary elasticity of demand. Still, the economics of the problem implies that supply shocks are partially offset by price variations which tend to stabilize labor incomes.

between stabilization policy losses and reductions in transactions costs associated with the creation of a monetary union. Relative to the planner's solution, the allocation under a strong central bank succeeds in producing optimal risk sharing. However, as in the case of multiple currencies, the labor supply decision is not first best.

4.4 Alternative Preferences

Under a strong monetary union, inactivity is optimal for the central monetary authority. However, this is a consequence of the fact that Cobb-Douglas preferences have the special property of constant budget shares. It is precisely because of this unitary elasticity of demand that nominal incomes are stabilized across countries without the need for transfers from the central bank.

To consider an alternative specification, suppose that preferences are instead given by:

$$\log(\theta c_{t+1}^{Eh} + (1-\theta)c_{t+1}^{Ef}) - g(n_t). \tag{37}$$

With this preference structure, labor supply is still given by the condition of

$$n_t g'(n_t) = 1$$

but, in contrast to the Cobb-Douglas specification, aggregate budget shares will depend on realizations of (q_t, q_t^*). In particular, if agents have identical, nonstochastic, symmetric preferences with $\theta = .5$, then, in equilibrium, $p_t = p_t^*$.[20] This implies that nominal GDP in the home country relative to the nominal GDP of the foreign country is given by q_t/q_t^* since all agents produce the constant level of output $\overline{n}$. So, if shocks are perfectly correlated across countries, then risk sharing remains optimal even with an inactive central bank.

If employment shocks are not perfectly positively correlated, nominal GDP in the home country will not equal nominal GDP in the foreign country. Hence, risk sharing across countries will be imperfect in the absence of central bank intervention. In fact, the central bank should create money and transfer it to the fiscal authority of the government in the country with the low level of nominal GDP. Given these funds, the fiscal authorities will

[20] Clearly in this example there are no gains to monetary union since $var(\theta) = 0$. The point we make about the need for central bank intervention would easily extend to an example with taste shocks as long as the equilibrium required $p_t = p_t^*$.

equalize the nominal incomes of employed and unemployed agents. In effect, the optimal central bank rule is to stabilize nominal GDP and not necessarily prices.

In equilibrium, this equalization of nominal incomes will lead to efficient allocations of risk both within and across countries. So, the first best allocation of risk can be supported but, as this example illustrates, this outcome will generally require an active central bank. One might interpret this as a form of fiscal federalism given the ability of the central bank to redistribute real wealth across countries. Of course, the central bank is doing so through money creation rather than direct taxation.

5 Weak Monetary Union

The results obtained thus far indicate that concerns over the loss of stabilization policy through the creation of a monetary union may not be justified. However, it is important to realize that these results reflect two strong assumptions about the conduct of monetary policy:

- the central bank was able to choose monetary policy before the national authorities selected fiscal variables,
- both the central bank and the fiscal authorities had a rich set of state contingent policy instruments at their disposal.

This section of the paper focuses on stabilization policy under alternative institutional structures which relax these strong assumptions. In the first case, we retain the assumption that the central bank has commitment power vis-a-vis the fiscal authorities but impose restrictions on the set of instruments available to the fiscal authorities. We term this a "fiscally constrained monetary union".

In the second case, we weaken the central bank along two dimensions. First, we restrict the nature of the contingencies associated with monetary transfers so that the distribution of seignorage is the same across countries and independent of employment shocks. Second, we relax the assumption that the central bank has commitment power relative to the fiscal authorities.[21]

[21] Chari-Kehoe [1997] make a similar point in a two-period, non-stochastic, reduced form model with government debt and money. Their infinite horizon model provides a more formal argument but is essentially a two-period structure.

5.1 A Fiscally Constrained Monetary Union

Given that the fiscal authorities retain stabilization tools (income taxes) and that the monetary authority has the ability to create money in order to stabilize nominal GDP then there are no stabilization losses associated with monetary union. But what if some of these instruments are missing?[22]

Suppose, for example, that the fiscal authorities are unable to set tax rates contingent on the realized value of the employment shock: i.e., assume $\tau = \tau^* = \bar{\tau}$. In the multiple currency institution, this is not a problem since the condition for efficient risk sharing can be satisfied by the appropriate choice of a money creation rate by the country specific monetary authority.

However, with the creation of a monetary union, the fiscal authorities will lose this stabilization tool. Is this **fiscally constrained monetary union** still desirable relative to a world economy with multiple currencies? With these restrictions:

Proposition 6 *In a fiscally constrained monetary union, (i) if* $corr(q_t, q_t^*) = 1$, *the allocation is identical to that obtained under strong monetary union, (ii) if shocks are sufficiently correlated across countries and tastes are sufficiently variable, then the monetary union allocation will dominate the outcome with multiple currencies and (iii) if employment shocks are not perfectly positively correlated and taste shocks are not sufficiently variable, then monetary union will not be welfare improving.*

Proof. See appendix. ■

Recall that we have assumed the central monetary authority can make country specific transfers. In this case, it is feasible for the common central bank to make monetary transfers to the individual governments necessary to finance their unemployment insurance schemes. In fact, given the fixed tax rates the monetary authority can print and transfer money to the fiscal authorities to guarantee that the incomes of employed and unemployed agents are equated, *within* a country. However, in the resulting allocation, income levels and thus consumptions of agents *across* countries will not be equated unless the employment shocks

[22] Or, equivalently what if there are more "shocks" than instruments? In fact, consideration of this question leads one to wonder about the determination of the number of policy instruments. In the absence of a theory of policy instruments, we take the set of tools available to policymakers as exogeneous but recognize that this is a rather strong assumption. For example, a country that had previously relied upon seignorage might develop an income tax system upon joining a monetary union.

are perfectly positively correlated. Thus, in contrast to the allocations characterized in Proposition 5, risk sharing is imperfect unless $corr(q_t, q_t^*) = 1$.

In fact, if shocks are perfectly correlated, the allocation in the fiscally constrained monetary union will be identical to that achieved under strong monetary union. In the language of instruments and targets, the perfect correlation of the shocks implies that one less instrument is needed so that the monetary authority can generate full insurance with its two instruments. If $corr(q_t, q_t^*) \neq 1$, then there is clearly a loss in stabilization from the creation of a monetary union. In this case, a tradeoff emerges: there are liquidity gains from a monetary union that are increasing in the variability of the taste shocks and stabilization losses that depend on $corr(q_t, q_t^*)$.

Of course, as suggested by Mundell, these considerations lead to predictions about which types of economies are natural candidates for a monetary union. Economies with positively correlated shocks who trade with one another (so that there are indeed gains from trade and the reduction of transactions costs) will profit from monetary union.

5.2 Constrained Central Bank

Instead of restricting the nature of interventions by the fiscal authorities, suppose that the central bank had limited powers of intervention. In particular, consider a central bank which was forced to equalize monetary transfers to the national governments. While our model contains no rationale for this restriction, to the extent that central banks (such as the ECB) are constrained in this manner, we can evaluate monetary union under these conditions.

As a starting point, consider again Proposition 4. In that setting, the first-best allocation of risk was attained **without** intervention by the central bank. Thus for our baseline model, there is no impact of constraining the central bank.

Now suppose that we consider the implications of a constrained central bank along with the constraints on the fiscal authorities imposed above: $\tau = \tau^* = \bar{\tau}$. In this case, a version of Proposition 6 holds. If the correlation of shocks is equal to 1, then the central bank will not have any incentive to differentiate transfers to the countries. By continuity, if this correlation is near 1, then the welfare losses from the additional contraints on the central bank will be minimal and thus monetary union continues to dominate the allocation with multiple currencies. At the other extreme, if the taste shocks are not too variable and employment shocks are not perfectly positively correlated, then monetary union will still

not be welfare improving. Clearly, adding more restrictions to monetary union once fiscal constraints are in place will not be welfare improving.

The welfare costs of a constrained central bank will be larger if preferences are not Cobb-Douglas. As we have seen for the specification in which goods are perfect substitutes, an active monetary policy with unequal transfers to countries is desirable even if the fiscal authorities are unconstrained.

5.3 Weak Central Bank

We define a *weak* central bank by two institutional features: *(i)* the two national fiscal authorities move first but act non-cooperatively and *(ii)* the central monetary authority moves second and fully finances the total sum of national deficits of the two governments. In other words, such a weak central bank functions under a full bail-out clause in which it is committed to meeting the financial needs of the fiscal authorities of member governments.

There are a number of reasons for being interested in such an institution. First, by looking at this extreme, one can better understanding the benefits of imposing a no bail-out clause, as appears to be the case in the European Monetary Union. Second, to the extent that a central bank cannot commit to a no-bail out clause, understanding the outcomes in this extreme case are of interest.[23] Third, there are examples of countries in which independent authorities interacted through a common central bank leading, in some cases, to excessive inflation.[24] Finally, though our model has no interest bearing government debt, the weak monetary union case captures the implications of a monetary authority which monetizes the debt of fiscal authorities.[25]

Given that the three government actors (the two fiscal authorities and the monetary

[23]In fact, Beetsma and Uhlig [1997] motivate their study of the "Stability Pact" by noting ".. there is fear that a high deficit member country or a member country in recession may successfully pressure the ECB into loosening its monetary policy."

[24]Some empirical evidence on that point is discussed in the conclusion. There are other studies of the interaction between independent parts of a government that share a common budget constraint. See, for example, Aizenman [1992], Aizenman and Powell [1998], Zarazaga[undated] and Chari and Kehoe [1997] for discussions of this point in the context of macroeconomics.

[25]As noted earlier, this coordination of policy issue arises in Sargent-Wallace [1981]. In the appendix of that paper, they outline a overlapping generations model with government debt, private storage and money as alternative assets. Through restricted participation in asset markets, they characterize an equilibrium in which the real rate of return exceeds the growth of the economy. The consequence of this for the case in which the monetary authority moves after the fiscal authority, in their words, is "Sooner or later in a monetarist economy the result is additional inflation."

authority) face two constraints, the policy choices must be interrelated. Here, we suppose that the monetary authority must respond to the choices of the independent fiscal authorities. Its strategy is then easily defined: it is obligated to monetize deficits.

5.3.1 Equilibrium Analysis

As the interaction between the government entities is the only difference between this structure and the strong central bank case, we use conditions of individual optimality from that case to characterize the consumption and labor supply decision rules of agents given monetary and fiscal policies. As before, each government provides unemployment insurance to agents currently unemployed. These flows are financed by tax revenues from employed agents and from the printing of money. Since the central bank is **required** to finance the deficits of the two governments, the evolution of the money supply is given by:

$$M_{t+1} = M_t + [(1-q_t)b_t^W - p_t n_t q_t \tau_t^W] + [(1-q_t^*)b_t^{*W} - p_t^* n_t^* q_t^* \tau_t^*] = M_t + \Delta_t^W + \Delta_t^{*W}. \quad (38)$$

where Δ_t^W (Δ_t^{*W}) denote the monetary deficit in the home (foreign) country, b_t^W the transfer to the unemployed and τ_t^W (τ_t^{*W}) the tax rate set in a "weak" environment. Put differently, the change in the money supply equals the sum of the nominal deficits across the two countries.

An important element of this institution is made apparent by this expression. The weak monetary union introduces an interaction across the fiscal authorities that did not exist in either the multiple currency or strong monetary union cases. Specifically, under a weak monetary union, deficit spending by one country is financed by an inflation tax that is partially paid by the agents of the other country. Thus the "beggar thy neighbor" type seignorage policies that promoted gains to monetary union in the multi-currency world economy of Cooper-Kempf [1998] reappear here under a weak central bank.[26]

Taking the response of the weak monetary authority as given, each fiscal authority in period t noncooperatively chooses the level of taxes and UI benefits to maximize the expected utility of generation t agents. In doing so, each government fully perceives the effects of its

[26]Interestingly, these effects were absent in the other institutional settings. This is a consequence of our timing assumptions: agents were able to go to exchange markets after receiving government transfers. In contrast, Cooper-Kempf [1998] assume that the transfers are received after the exchange markets are closed thus providing a tax base for seignorage.

policies on equilibrium prices.

In general, characterizing additional features of this equilibrium is difficult since the presence of country specific shocks implies that the distribution of the nominal money supply across the two countries is stochastic. Hence in the remainder of this section we make an additional assumption that the economies are symmetric: $\overline{\theta} = \frac{1}{2}$. Let D_t represent the level of nominal spending in period $t+1$ on the home good by generation t (home and foreign) agents. D_t is also the nominal income of generation $t+1$ employment agents. Hence, from market clearing:

$$p_{t+1}q_{t+1}\overline{n} = D_t = \overline{\theta}(q_t I_t^E + (1-q_t)I_t^U) + (1-\overline{\theta})(q_t^* I_t^{*E} + (1-q_t^*)I_t^{*U}). \tag{39}$$

Using $\overline{\theta} = \frac{1}{2}$, the evolution of D_t is given by:

$$D_t = \frac{1}{2}[D_{t-1} + D_{t-1}^* + \Delta_t^W + \Delta_t^{*W}]. \tag{40}$$

With this added structure we find:

Proposition 7 *With $\overline{\theta} = \frac{1}{2}$, there is a symmetric equilibrium in which all income taxes are zero and $\Delta_t^W = 2\frac{(1-q_t)}{(q_t+q_t^*-1)}D_{t-1}$, $\Delta_t^{*W} = 2\frac{(1-q_t^*)}{(q_t+q_t^*-1)}D_{t-1}^*$ and $D_t = D_t^*$ for all t.*

Proof. See appendix. ■

According to this proposition, when the central bank is weak, there is no direct taxation by either country to finance transfers to its unemployed people. To the contrary, all transfers are fully monetized.[27] This indeed can be very simply understood. Suppose an adverse shock hits the home economy. The home fiscal authority has two alternative ways to raise compensation to the unemployed: it can either tax its currently employed agents or ask the weak central bank to finance its transfers. Using this inflation tax is a dominant strategy for each of the governments since part of the tax burden is borne by agents outside their country. Nevertheless there is a limit to the amount raised through monetization since the higher prices lead to a reduction in the utility of young employed agents.

The equilibrium is symmetric: each country runs a deficit in each period which is proportional to the level of nominal spending in that country. The rates of money creation are

[27] In some countries, such as Argentina, Brazil and Russia, there is vivid evidence of the inflation predicted by this proposition. We discuss this in our conclusions.

dependent on the level of unemployment in each of the countries. Since the deficit spending is used to finance a transfer to unemployed agents which is partially paid for by the employed agents, it is natural that the rate of money creation should be an increasing function of the unemployment rate in the home country.

The equilibrium rate of money creation is given by:

$$\sigma_t^W = \frac{2 - q_t - q_t^*}{q_t + q_t^* - 1}. \tag{41}$$

Clearly, money growth is zero if both economies exhibit full employment and is increasing in the rates of unemployment of member countries.

5.3.2 Welfare Comparisons

A characteristic of a weak monetary union is that incomes of unemployed and employed agents are not equalized within a country. Hence, as they face the same prices, their consumption allocations will not be the same, for a given realization of the taste shock θ. So, the allocation under a weak monetary union will not satisfy the conditions for optimal risk sharing: this institution does not facilitate stabilization through the available policy instruments. Instead, these fiscal policies are used strategically in order to induce the central monetary authority to create money. This leads us to study the welfare properties of a weak monetary union, compared to a strong monetary union as well as the allocation obtained with multiple currencies.

Weak vs. Strong Central Bank In the institution of a monetary authority with commitment, there were no insurance losses associated with monetary union: the fiscal authorities provide insurance within a country and the monetary authorities, by maintaining a constant money supply, enabled the price system to insure nominal incomes. In the weak monetary union institution, the liquidity gains may be offset by the welfare loss associated with the seignorage game between countries. In fact,

Proposition 8 *The allocation under strong monetary union provides all agents with higher expected utility than the allocation under a weak monetary union.*

Proof. See appendix. ■

For the weak central bank, Proposition 7 indicates that the extent to which countries will inflate via the common central bank depends on their individual countries rates of unemployment. Hence, if unemployment rates are sufficiently low on average and not too volatile, then a monetary union will not create excessive inflation.

Comparing this result for a weak monetary union with that for the constrained fiscal structure, Proposition 6, is instructive. For both cases, we see that in order for monetary union to be welfare improving, taste shocks must be sufficiently variable. For both cases, there are potentially significant costs from monetary union but, interestingly, these costs depend on different parameters. In the presence of a weak central bank, a country is adversely affected by the inflationary policies of other countries. In contrast, the key to the fiscal constrained structure, as demonstrated in Proposition 6, is the correlation of shocks.

6 Conclusion

The goal of this paper has been to examine the effectiveness of stabilization policy within a monetary union. To do so, we explored the allocations of a stochastic two-country overlapping generations model under alternative monetary/fiscal institutions.

In the extreme case of a strong central monetary authority with commitment power and fiscal authorities with the ability to set state contingent tax rates, a monetary union unambiguously increases welfare. In this institutional design, the delegation of monetary policy to a single central bank does not jeopardize the conduct of stabilization policy. The tradeoff envisioned by Mundell and others does not exist. Further, the gain to monetary union does not rest on labor mobility since in our model, by construction, labor is immobile.

However, there are designs of a monetary union which do not increase welfare precisely because stabilization policy is impaired. In particular, if the set of policy instruments open to fiscal authorities is sufficiently restricted, then monetary union may not increase welfare. Despite having commitment power, the central bank lacks the tools to stabilize in the presence of country specific shocks that are not perfectly correlated.

Further, if the monetary authority is weak and thus influenced by the deficit spending of member countries, then the gains to monetary union may be more than offset by the adverse consequences of inflation. A weak central bank opens the door to strategic interaction by the fiscal authorities and thus to excessive inflation.

These results are normative in that they point to potential gains from monetary union. Will these gains be realized? Cooper-Kempf [1998] argue that though there are gains to a monetary union, the incentives for each country imply that these welfare gains will not be realized without collective action. In particular, Cooper-Kempf [1998] find that a game in which countries, in effect, decide to join a monetary union or not has a prisoners' dilemma structure: the cooperative outcome of monetary union is not a Nash equilibrium of this game. Those results can be extended to the environment studied here.

Some general lessons can be drawn from this analysis. On the issue of commitment vis-a-vis the fiscal authorities, two elements seem important. First, central bank independence and fiscal pacts (as enforced for example in the EMU) seem important insofar as they reduce pressures on the monetary authority. While not formally part of our model, clearly restrictions on deficits would limit the "beggar thy neighbor" type inflation that could undermine monetary union. Second, the monetary authority must adopt rules that insulate its decisions from the fiscal pressures exerted by member governments.[28] In this regard, rules that specify growth rates for monetary aggregates seem more desirable relative to rules that respond to fiscal policy through, for example, the stabilization of interest rates. But on the other hand, it is important to leave enough room to allow policy stabilization. On that account, the fiscal pact and the no-bail clause used in the EMU may prove to be too constraining in the future.[29]

On the issue of determining which groups of countries might benefit from a monetary union, two factors should be kept in mind. First, one of the gains we have identified pertains to the reduction in consumption misallocations from the adoption of a single currency. Clearly these gains are larger the more the countries trade with one another. Second, unless the central bank is sufficiently strong and fiscal authorities are sufficiently active in the conduct of stabilization policy, the delegation of monetary policy will entail some stabilization losses. If so, our results point to the fact that countries with a high correlation of shocks will suffer less from the centralization of monetary policy.

Even though these findings are rather abstract, we do think that they provide useful insights on actual or possible monetary unions. For the U.S., Rolnick, Smith and Weber

[28] For the case of Argentina, Saiegh and Tommasi [1999] discuss the Convertibility Law of 1991 as a means of limiting inflationary pressures.

[29] Clearly this discussion suggests an interesting extension of our analysis would be to evaluate a variety of monetary rules in a version of the model with government debt.

[1993] develop an argument linking the clause in the U.S. Constitution which created a central monetary authority with a desire to avoid seignorage games between colonies. On the fiscal side, Poterba [1996] discusses the nature of balanced-budget rules across states. The centralization of monetary authority along with these fiscal constraints seems sufficient to eliminate the seignorage games.

Aizenman [1998] discusses the experiences of Brazil and Argentina from this perspective. Saiegh and Tommasi [1999] discuss the recent experience of Argentina in terms of a weak central bank responding to the actions of independent fiscal entities.[30] A similar fate happened in the infancy of the Community of Independent States in the early 1990s, when local authorities had the ability to finance local expenditures through the creation of rubles by the Russian Central Bank. Inflation has been put under control when the Russian Central Bank stopped bailing out public governments.[31] Our theoretical model makes clear a major root of these hyperinflationary episodes: the laxity of monetary authorities and the noncooperative behavior of fragmented fiscal authorities leading to seignorage games.

In terms of further analysis, three important extensions come to mind. First, our analysis of stabilization policy looks exclusively at supply shocks. This is relevant since these shocks produce price movements which tend to stabilize nominal incomes. As noted earlier, this feature of markets created an element of stability even with a non-interventionist monetary authority. Clearly, extending the analysis to a setting with demand side shocks and thus no countervailing price movements is of interest.

Second, the issue of stabilization policy in a monetary union could be pursued by analyzing the consequences of fiscal federalism. Such an institutional arrangement adds new fiscal instruments by facilitating interregional transfers. However, the case of strong monetary union in which the central bank has the ability to make state contingent transfers that differ across countries nests any fiscal federalism scheme. Hence, the study of fiscal federalism requires additional restrictions on the conduct of monetary policy.

Third, there is another monetary arrangement that is closely related to monetary union: the adoption of the currency of another country.[32] We term this regime "dollarization"

[30]For the case of Argentina, the fiscal deficits of the individual provinces are actually financed jointly through national taxation and the printing of money.

[31]See, for example, the discussion in V. Koen and M. Marrese [1995] and T. J. Balinos, D. Hoelscher and J. Horder [1997].

[32]See, for example, the recent analysis of Bencivenga et al. [1999] on dollarization in a setting where

in recognition of the use of the U.S. dollar in a number of Latin America countries, such as Panama, Ecuador and possibly Argentina. This structure is similar to monetary union except that the choice of stabilization through monetary policy remains with one of the countries. Of interest is understanding how this relationship compares to the environment of multiple currencies and to monetary union.

capital market integration is central.

7 References

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APPENDIX

1 Proof of Proposition 1

The planner solves

$$\max_{c(s,\theta),c^*(s,\theta^*),n(s),n^*(s)} E_s\{q_{-1}U^{Eh} + (1-q_{-1})U^{Uh} + q^*_{-1}U^{*Eh} + (1-q^*_{-1})U^{*Uh} \\ -qg(n(s)) - q^*g(n^*(s))\} \tag{44}$$

subject to:

$$E_{\theta,\theta^*}[q_{-1}c^{Eh}(s,\theta)+(1-q_{-1})c^{Uh}(s,\theta)+q^*_{-1}c^{*Eh}(s,\theta^*)+(1-q^*_{-1})c^{*Uh}(s,\theta^*)] = n(q,q^*)q \tag{45}$$

$$E_{\theta,\theta^*}[q_{-1}c^{Ef}(s,\theta)+(1-q_{-1})c^{Uf}(s,\theta)+q^*_{-1}c^{*Ef}(s,\theta^*)+(1-q^*_{-1})c^{*Uf}(s,\theta^*)] = n^*(q,q^*)q^*. \tag{46}$$

Denoting λ and λ^* the multipliers associated with the two constraints, the first-order conditions imply:

$$\begin{aligned} \frac{\theta}{c^{Eh}(s,\theta)} &= \frac{\theta}{c^{Uh}(s,\theta)} = \frac{1-\theta^*}{c^{*Eh}(s,\theta^*)} = \frac{1-\theta^*}{c^{*Uh}(s,\theta^*)} = \lambda \\ \frac{1-\theta}{c^{Ef}(s,\theta)} &= \frac{1-\theta}{c^{Uf}(s,\theta)} = \frac{\theta^*}{c^{*Ef}(s,\theta^*)} = \frac{\theta^*}{c^{*Uf}(s,\theta^*)} = \lambda^* \end{aligned}$$

for all s, θ, θ^*. Further:

$$\lambda = g'(n) \text{ and } \lambda^* = g'(n^*)$$

Using the resource constraint to solve for λ and λ^*, the first-best allocation is characterized by:

$$\frac{\theta}{c^{Eh}(s,\theta)} = \frac{\theta}{c^{Uh}(s,\theta)} = \frac{(1-\theta^*)}{c^{*Eh}(s,\theta^*)} = \frac{(1-\theta^*)}{c^{*Uh}(s,\theta^*)}$$

for all (θ,θ^*), and

$$g'(n)nq = 1 = \dot{g}'(n^*)n^*q^*$$

as in the proposition.

2 Proof of Proposition 2

A. The maximization problem of an employed agent

The maximization problem solved by an employed, generation t home agent is:

$$\max_{n_t, m_t^{Eh}, m_t^{Ef}} E_\theta \left\{ \theta_{t+1} \ln \left(c_{t+1}^{Eh} \right) + (1 - \theta_{t+1}) \ln \left(c_{t+1}^{Ef} \right) \right\} - g(n_t) \tag{47}$$

$$s.t. \qquad p_t (1 - \tau_t) n_t = m_t^{Eh} + e_t m_t^{Ef} \tag{48}$$

$$p_{t+1} c_{t+1}^{Eh} = m_t^{Eh} \qquad p_{t+1}^* c_{t+1}^{Ef} = m_t^{Ef} \tag{49}$$

The first-order conditions lead to two equalities:

$$g'(n_t) = \frac{p_t (1 - \tau_t) \left(1 - \overline{\theta} \right)}{e_t p_{t+1}^* c_{t+1}^{Ef}} \qquad \frac{\overline{\theta}}{1 - \overline{\theta}} = \frac{p_{t+1} c_{t+1}^{Eh}}{e_t p_{t+1}^* c_{t+1}^{Ef}} \tag{50}$$

Hence:

$$n_t g'(n_t) = \frac{n_t p_t (1 - \tau_t) \left(1 - \overline{\theta} \right)}{e_t p_{t+1}^* c_{t+1}^{Ef}} = \frac{\frac{1}{q_t} M_t (1 - \tau_t) \left(1 - \overline{\theta} \right)}{\frac{1}{q_t} M_t (1 - \tau_t) - m_t^{Eh}}$$

using the individual budget constraint and where $M_t \equiv p_t q_t n_t$ is the total amount of home money in circulation at period t. Defining

$$m_t^{Eh} \equiv \phi_t^E \cdot \frac{1}{q_t} M_t (1 - \tau_t)$$

and assuming that $\phi_t^E = \phi^E$, it is deduced that:

$$n_t g'(n_t) = \frac{1 - \overline{\theta}}{1 - \phi^E}$$

which implies that n_t is constant over time and denoted by $\overline{n}$.

Remark then that:

$$p_t (1 - \tau_t) n_t = \frac{1}{q_t} M_t (1 - \tau_t) = \frac{m_t^{Eh}}{\phi^E}$$

and we get:

$$\frac{\overline{\theta}}{1 - \overline{\theta}} = \frac{p_{t+1} c_{t+1}^{Eh}}{e_t p_{t+1}^* c_{t+1}^{Ef}} = \frac{m_t^{Eh}}{\frac{1}{q_t} M_t (1 - \tau_t) - m_t^{Eh}} = \frac{\phi^E}{1 - \phi^E}$$

which implies that $\overline{\theta} = \phi^E$ and $\overline{n}g'(\overline{n}) = 1$. It is then easy to obtain the levels of consumption for an employed agent. From above, we can write that:

$$c_{t+1}^{Eh} = \frac{\overline{\theta}}{q_t}\frac{M_t(1-\tau_t)}{p_{t+1}}\frac{\overline{\theta}}{q_t}\frac{M_t}{M_{t+1}} = (1-\tau_t)\,q_{t+1}\overline{n} = \overline{\theta}\overline{n}\frac{q_{t+1}}{q_t}\frac{(1-\tau_t)}{(1+\sigma_t)} \tag{51}$$

since $M_{t+1} \equiv p_{t+1}q_{t+1}n$.

B. The maximization problem of an unemployed agent

The maximization problem solved by an unemployed, generation t, home agent is:

$$\max_{m_t^{Uh}, m_t^{Uf}} E_\theta\left\{\theta_{t+1}\ln\left(c_{t+1}^{Uh}\right) + (1-\theta_{t+1})\ln\left(c_{t+1}^{Uf}\right)\right\} \tag{52}$$

$$s.t. \qquad I_t^U = m_t^{Uh} + e_t m_t^{Uf} \tag{53}$$

$$p_{t+1}c_{t+1}^{Uh} = m_t^{Uh} \qquad p_{t+1}^* c_{t+1}^{Uf} = m_t^{Uf} \tag{54}$$

The first-order conditions lead to the following inequality:

$$\frac{\overline{\theta}}{1-\overline{\theta}} = \frac{p_{t+1}c_{t+1}^{Uh}}{e_t p_{t+1}^* c_{t+1}^{Uf}}$$

Defining $m_t^{Uh} \equiv \phi_t^U \cdot I_t^U$ and assuming that $\phi_t^U = \phi^U$, it follows from the individual budget constraint that:

$$\frac{\overline{\theta}}{1-\overline{\theta}} = \frac{\phi^U}{1-\phi^U}$$

which implies that $\phi^U = \overline{\theta} = \phi^E$. Then the following expressions hold:

$$\begin{aligned} q_t e_t m_t^{Ef} &= \left(1-\overline{\theta}\right)(1-\tau_t)\,M_t \\ (1-q_t)\,e_t m_t^{Uf} &= \left(1-\overline{\theta}\right)(\tau_t+\sigma_t)\,M_t \end{aligned}$$

implying:

$$e\left[q_t m_t^{Ef} + (1-q_t)\,m_t^{Uf}\right] = \left(1-\overline{\theta}\right)(1+\sigma_t)\,M_t.$$

Using a similar reasoning for the foreign economy, we get from the clearing condition on the

exchange market the following equality:

$$\left[q_t^* m_t^{*Ef} + (1 - q_t^*) m_t^{*Uf}\right] = \left(1 - \overline{\theta}\right)(1 + \sigma_t^*) M_t^*$$

or equivalently:

$$M_{t+1} = M_{t+1}^* e_t.$$

Given that the equality between money supply and the aggregate nominal product in one country, this immediately implies that:

$$\frac{p_t}{e_t p_{t+1}^*} = \frac{q_t^*}{q_t}. \tag{55}$$

We then easily get the levels of consumption given in the proposition.

3 Proof of Proposition 3

The maximization problem solved by the home government can be written as follows:

$$\begin{aligned} &\max_{\tau_t^F, \sigma_t^F} E_\theta \left(q_t U\left(c_{t+1}^{Eh}, c_{t+1}^{Ef}\right) + (1 - q_t)\left(U\left(c_{t+1}^{Uh}, c_{t+1}^{Uf}\right)\right)\right) \\ &given \qquad \tau_t^{*F}, \sigma_t^{*F}. \end{aligned} \tag{56}$$

Denoting $\xi_t \equiv \frac{\left(1-\tau_t^F\right)}{\left(1+\sigma_t^F\right)}$ and given the expressions for the various levels of consumption, the first-order condition generates the following equality:

$$\xi_t = q_t. \tag{57}$$

4 Proof of Proposition 4

Any government takes the transfer received by his unemployed agent from the central monetary authority, Δ_t^S, as given. The first order conditions for the agents' programs and the resulting consumption levels and supply levels allow us to write the optimization program of the home government as follows:

$$\max E\left\{q_t \ln\left(I_t^E\right) + (1 - q_t)\ln\left(I_t^U\right) - \overline{\theta}\ln\left(p_{t+1}\right) - \left(1 - \overline{\theta}\right)\ln\left(p_{t+1}^*\right)\right\} \tag{58}$$

$$s.t. \qquad I_t^E = p_t\overline{n}\left(1-\tau_t^S\right) \qquad I_t^U = p_t\overline{n}\tau_t^S\frac{q_t}{1-q_t}+\frac{\Delta_t^S}{1-q_t} \tag{59}$$

The first-order condition for the home government implies $I_t^E = I_t^U$. Using this condition, the home and foreign tax rates are given by:

$$\tau_t^S = (1-q_t) - q_t\frac{\Delta_t^S}{p_t q_t \overline{n}} \qquad \tau_t^{*S} = (1-q_t^*) - q_t^*\frac{\Delta_t^{*S}}{p_t^* q_t^* \overline{n}}.$$

Given the decisions rules of the fiscal authorities, the central monetary authority solves:

$$\begin{aligned}&\max E\left\{q_t \ln\left(I_t^E\right) + (1-q_t)\ln\left(I_t^U\right) + q_t^* \ln\left(I_t^{*E}\right) + (1-q_t^*)\ln\left(I_t^{*U}\right)\right.\\ &\left.-\ln\left(p_{t+1}\right) - \ln\left(p_{t+1}^*\right)\right\}\end{aligned} \tag{60}$$

$$\begin{aligned} s.t. \qquad I_t^E &= p_t\overline{n}\left(1-\tau_t^S\right) \qquad I_t^U = p_t\overline{n}\tau_t^S\frac{q_t}{1-q_t}+\Delta_t^S \\ I_t^{*E} &= p_t^*\overline{n}\left(1-\tau_t^{*S}\right) \qquad I_t^{*U} = p_t^*\overline{n}\tau_t^{*S}\frac{q_t^*}{1-q_t^*}+\Delta_t^{*S} \\ \tau_t^S &= (1-q_t) - q_t\frac{\Delta_t^S}{p_t q_t \overline{n}} \qquad \tau_t^{*S} = (1-q_t^*) - q_t^*\frac{\Delta_t^{*S}}{p_t^* q_t^* \overline{n}}. \end{aligned} \tag{61}$$

The first-order conditions are:

$$\frac{1}{I_t^U} - \frac{dp_{t+1}}{d\Delta_t^S}\frac{1}{p_t} - \frac{dp_{t+1}^*}{d\Delta_t^S}\frac{1}{p_t^*} = 0 \qquad \frac{1}{I_t^{*U}} - \frac{dp_{t+1}^*}{d\Delta_t^{*S}}\frac{1}{p_t^*} - \frac{dp_{t+1}}{d\Delta_t^{*S}}\frac{1}{p_t} = 0.$$

From market-clearing conditions, we find:

$$p_{t+1}q_{t+1}\overline{n} = E_{\theta,\theta^*}\left\{q_t\theta I_t^E + (1-q_t)\,\theta\, I_t^U + q_t^*\,(1-\theta^*)\, I_t^{*E} + (1-q_t^*)\,(1-\theta^*)\, I_t^{*U}\right\}.$$

Hence:

$$\frac{dp_{t+1}}{d\Delta_t^S} = \frac{\overline{\theta}}{q_{t+1}\overline{n}} \qquad \text{and} \qquad \frac{dp_{t+1}}{d\Delta_t^{*S}} = \frac{1-\overline{\theta}}{q_{t+1}\overline{n}}$$

and similarly:

$$\frac{dp_{t+1}^*}{d\Delta_t^S} = \frac{1-\overline{\theta}}{q_{t+1}^*\overline{n}} \qquad \text{and} \qquad \frac{dp_{t+1}^*}{d\Delta_t^{*S}} = \frac{\overline{\theta}}{q_{t+1}^*\overline{n}}.$$

Then, taking the values for the tax ratios into consideration, the first-order conditions imply that:

$$\frac{1}{p_t\overline{n}q_t + \Delta_t^S} - \frac{\overline{\theta}}{q_{t+1}\overline{n}p_t} - \frac{1-\overline{\theta}}{q_{t+1}^*\overline{n}p_t^*} = 0, \tag{62}$$

$$\frac{1}{p_t^*\overline{n}q_t^* + \Delta_t^{*S}} - \frac{\overline{\theta}}{q_{t+1}^*\overline{n}p_t^*} - \frac{1-\overline{\theta}}{q_{t+1}\overline{n}p_t} = 0. \tag{63}$$

We assume $\Delta_t^S = \Delta_t^{*S} = 0$ is a solution and show it is consistent with the first-order conditions. If $\Delta_t^S = \Delta_t^{*S} = 0$, we verify from the first order conditions of the individual governments that incomes are equal irrespective of employment status. This equality of incomes requires

$$\tau_t^S = (1 - q_t) \qquad \tau_t^{*S} = (1 - q_t^*). \tag{64}$$

Second-order conditions ensure that it is the only solution. The consumption and employment allocations for home agents are then obtained by evaluating (12)-(13) given these policy choices. Similar expressions hold for foreign agents. ■

5 Proof of Proposition 5

Proof. This expression for Λ_{SF} comes directly from the difference between (11) and (16). Taking the second-order Taylor approximation of this expression, this gain associated to strong monetary union can be viewed as:

$$\Lambda_{SF} = \frac{1}{2} * var\,(\theta)\,[\frac{1}{\overline{\theta}} + \frac{1}{(1-\overline{\theta})}].$$

$\Lambda_{SF} > 0$ if $var(\theta) > 0$ as $\overline{\theta}\epsilon(0,1)$. ■

6 Proof of Proposition 6

We let C, as a superscript or a subscript, denote variables for the constrained monetary union case. The maximization problem of the monetary authority is similar to the problem explored in the proof of Proposition 4, with the restriction that: $\tau = \tau^* = \tau^C$. The first-order

conditions then become:

$$\frac{1}{p_t\overline{n}\tau^C\frac{q_t}{1-q_t}+\Delta_t^C}-\frac{\overline{\theta}}{q_{t+1}\overline{n}p_{t+1}}-\frac{1-\overline{\theta}}{q_{t+1}^*\overline{n}p_{t+1}^*} = 0 \tag{65}$$

$$\frac{1}{p_t^*\overline{n}\tau^C\frac{q_t^*}{1-q_t^*}+\Delta_t^{*C}}-\frac{\overline{\theta}}{q_{t+1}^*\overline{n}p_{t+1}^*}-\frac{1-\overline{\theta}}{q_{t+1}\overline{n}p_{t+1}} = 0 \tag{66}$$

(i) Suppose that the monetary transfers ensure perfect income equalization within the monetary union, given the fixed tax rate. Given the definitions of incomes, this implies:

$$I_t^U = I_t^E = \overline{n}\left(1-\tau^C\right)p_t = I_t^{*U} = I_t^{*E} = \overline{n}\left(1-\tau^C\right)p_t^*$$

hence: $p_t = p_t^*$. Using the market clearing equalities, the equalization of prices is equivalent to $q_t = q_t^*$, or $corr\,(q,q^*) = 1$. Hence this is a solution to the governments problem iff $corr\,(q,q^*) = 1$. As we obtain the same allocation as under a strong monetary union, we get that $V_S = V_C$ iff $corr\,(q,q^*) = 1$.

(ii) Suppose that $corr\,(q,q^*)$ is near 1 and the variance of taste shocks is positive. From Proposition 5, $V_S > V_F$ when $var(\theta) > 0$. Since $V_S = V_C$ when $corr\,(q,q^*) = 1$ by continuity, $V_C > V_F$ when $corr\,(q,q^*)$ is near 1.

(iii) Suppose that $var\,(\theta) = 0$. This implies that $V_S = V_F$ (from Proposition 5). Yet, when $corr\,(q,q^*) \neq 1, V_S > V_C$. Hence when taste shocks are not too volatile and $corr\,(q,q^*) \neq 1$, $V_F > V_C$.

7 Proof of Proposition 7

Given the expressions for consumption levels and using the fact that $n_t = \overline{n}$, the maximization problem of the home government can be rewritten as:

$$\max\left\{q_t \ln I_t^E + (1-q_t)\ln I_t^U - \overline{\theta}\ln p_{t+1} - (1-\overline{\theta})\ln p_{t+1}^* + \lambda\tau_t^W\right\} \tag{67}$$

$$s.t. \qquad I_t^E = p_t\overline{n}\left(1-\tau_t^W\right) \qquad I_t^U = \frac{1}{1-q_t}\left[p_t\overline{n}\tau_t^W q_t + \Delta_t^W\right] \tag{68}$$

where λ is the multiplier associated with $\tau_t \geq 0$. In this optimization problem the home government recognizes the effect of its policies on the equilibrium prices. The market clearing

conditions can be written as:

$$1 = \overline{\theta}\frac{I_t}{D_t} + \left(1-\overline{\theta}\right)\frac{I_t^*}{D_t} \qquad 1 = \overline{\theta}\frac{I_t^*}{D_t^*} + \left(1-\overline{\theta}\right)\frac{I_t}{D_t^*} \tag{69}$$

where D_t (D_t^*) is $p_{t+1}q_{t+1}\overline{n}$ ($p_{t+1}^*q_{t+1}^*\overline{n}$), $I_t = q_tI_t^E + (1-q_t)I_t^U$ and $I_t^* = q_tI_t^{*E} + (1-q_t)I_t^{*U}$. Using these market clearing conditions, the derivatives of prices with respect to the transfers are:

$$\frac{\frac{\partial p_{t+1}}{\partial \Delta_t^W}}{p_{t+1}} = \frac{\frac{1-q_t}{q_{t+1}}\frac{\overline{\theta}}{\overline{n}}}{p_{t+1}} = \frac{\overline{\theta}}{D_t} \qquad \frac{\frac{\partial p_{t+1}^*}{\partial \Delta_t^W}}{p_{t+1}^*} = \frac{\frac{1-q_t^*}{q_{t+1}^*}\frac{\overline{\theta}}{\overline{n}}}{p_{t+1}^*} = \frac{\left(1-\overline{\theta}\right)}{D_t^*}.$$

The effects of tax rates on prices is zero since spending is independent of the distribution of income within a country.

Using these results the two first-order conditions for the home government are:

$$-\frac{q_tp_t\overline{n}}{I_t^E} + \frac{(1-q_t)\,p_t\overline{n}\frac{q_t}{1-q_t}}{I_t^U} + \lambda = 0 \tag{70}$$

$$\frac{1}{I_t^U} - \left(\frac{\overline{\theta}^2}{D_t} + \frac{\left(1-\overline{\theta}\right)^2}{D_t^*}\right) = 0 \tag{71}$$

With $\overline{\theta} = 1/2$, (69) imply that $D_t = D_t^*$ for all t. Further, these conditions imply that

$$D_t + D_t^* = I_t + I_t^* \tag{72}$$

Using (71) and the analogous condition for the foreign country,

$$I_t^U = I_t^{*U} > D_t$$

since $\overline{\theta}^2 + (1-\overline{\theta})^2 < 1$. Hence, for (72) to hold,

$$I_t^E < D_t \qquad \text{and} \qquad I_t^{*E} < D_t^*.$$

This implies that the employed in each country have lower nominal income than the unemployed. Thus in order for (70) to hold, as well as the analogous condition for the foreign country, $\lambda > 0$ and $\lambda^* > 0$. So, tax rates must be zero in both countries.

As τ_t and τ_t^* are equal to 0, given the definitions of the monetary transfers, and $\overline{\theta} = 1/2$,

the FOCs for the home and foreign governments become:

$$\begin{aligned}\frac{1-q_t}{\Delta_t^W}-\frac{1}{4}\left[\frac{1}{q_{t+1}\overline{n}p_{t+1}}+\frac{1}{q_{t+1}^*\overline{n}p_{t+1}^*}\right] &= 0\\ \frac{1-q_t^*}{\Delta_t^{*W}}-\frac{1}{4}\left[\frac{1}{q_{t+1}\overline{n}p_{t+1}}+\frac{1}{q_{t+1}^*\overline{n}p_{t+1}^*}\right] &= 0\end{aligned}$$

From the market clearing conditions:

$$\begin{aligned}p_{t+1}q_{t+1}\overline{n} &= E_{\theta,\theta^*}\left\{q_t\theta I_t^E+(1-q_t)\,\theta I_t^U+q_t^*\,(1-\theta^*)\,I_t^{*E}+(1-q_t^*)\,(1-\theta^*)\,I_t^{*U}\right\}\\ p_{t+1}^*q_{t+1}^*\overline{n} &= E_{\theta,\theta^*}\left\{q_t^*\theta I_t^{*E}+(1-q_t^*)\,\theta I_t^{*U}+q_t\,(1-\theta)\,I_t^E+(1-q_t)\,(1-\theta)\,I_t^U\right\}\end{aligned}$$

we get when $\overline{\theta}=1/2$:

$$p_{t+1}q_{t+1}\overline{n}=p_{t+1}^*q_{t+1}^*\overline{n}=\frac{1}{2}\left[M_t+\Delta_t^W+\Delta_t^{*W}\right]$$

and the FOCs can be written:

$$\frac{1-q_t}{\Delta_t^W}=\frac{1}{2}\frac{1}{q_{t+1}\overline{n}p_{t+1}}\qquad\frac{1-q_t^*}{\Delta_t^{*W}}=\frac{1}{2}\frac{1}{q_{t+1}\overline{n}p_{t+1}}. \tag{73}$$

This implies:

$$\Delta_t^W=2\,(1-q_t)\cdot\frac{1}{2}\left[M_t+\Delta_t^W+\Delta_t^{*W}\right]$$

Finally we get the reaction functions:

$$\Delta_t=\frac{1-q_t}{q_t}\cdot\left[M_t+\Delta_t^{*W}\right]\qquad\Delta_t^{*W}=\frac{1-q_t^*}{q_t^*}\cdot\left[M_t+\Delta_t^W\right] \tag{74}$$

The Nash equilibrium of the game is then given by the following:

$$\Delta_t^W=\frac{1-q_t}{q_t+q_t^*-1}\cdot M_t\qquad\Delta_t^{*W}=\frac{1-q_t^*}{q_t+q_t^*-1}\cdot M_t \tag{75}$$

This completes the proof as $2D_{t-1}=M_t$. ■

8 Proof of Proposition 8

Note that under both designs, the employment and thus output levels are the same. Then, given the welfare function for the representative agent and the strict concavity of the utility function, an allocation of this ouput generating perfect risk sharing dominates an allocation which does not guarantee perfect risk sharing. ■

9 Proof of Proposition 9

Proof. Here we denote the welfare under the weak central bank allocation as V_W. If $var(\theta) = 0, V_F = V_S > V_W$, where the second inequality follows from Proposition 8 as long as $\bar{q}$ and $\bar{q}^*$ are below 1 so that there are some states with unemployment in one of the two countries. If the countries never experience unemployment so that $q_t = q_t^* = 1$ with probability one, then from Proposition 7, there is no inflation. In this case, $V_W = V_S > V_F$ as long as taste shocks are present. Hence by continuity, if q_t and q_t^* near one on average and not too volatile, then by continuity $V_W > V_F$. ■