

Fiscal Unions Redux

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A monetary union sets union-wide monetary policy in the hope of achieving desirable outcomes. When a monetary union is established, a classic question arises: How should the fiscal policies of member countries be coordinated? In particular, is it desirable to establish a union-wide authority to coordinate the fiscal policies of member countries as well as to implement international fiscal transfers between them? Amid the recent debate about the desirability of greater fiscal integration within the European Union, such a question has regained center stage.

Before the advent of sophisticated international financial markets, a widely accepted belief was that within a monetary union, a union-wide authority orchestrating fiscal transfers between countries is necessary to provide adequate insurance against country-specific economic fluctuations. A natural question is then: Do sophisticated international financial markets obviate the need for such an active union-wide authority? We argue that they do.

Specifically, we show that in a benchmark economy with no international financial markets, an activist union-wide authority is necessary to achieve desirable outcomes. With sophisticated financial markets, however, such an authority is unnecessary if its only goal is to provide cross-country insurance. Since restricting the set of policy instruments available to member countries does not create a fiscal externality across them, this result holds in a wide variety of settings. Finally, we establish that an activist union-wide authority concerned just with providing insurance across member countries is optimal only when individual countries are either unable or unwilling to pursue desirable policies.