The Role of Optimal Fiscal Policy in a Currency Union

OKANO, Eiji

Abstract

By constructing a dynamic stochastic general equilibrium model, this paper verifies the role of optimal fiscal policy in a currency union with nontradable goods. A single optimal monetary policy has a decisive role in enhancing welfare by stabilizing inflation and the output gap in each country simultaneously when all goods are tradable. However, because approximately half of all goods are nontradable in the Euro area, this result is not applicable. When nontradable goods exist, optimal monetary policy alone cannot maximize welfare because of a real exchange rate anomaly or the Balassa--Samuelson theorem, which holds that stabilizing inflation and the output gap in each country simultaneously cannot be achieved. In this case, an optimal monetary and cooperative optimal fiscal policy mix is essential to maximize welfare. Furthermore, we show that a self-oriented setting can bring about an optimal allocation that corresponds to one brought about by a cooperative setting.