Asymmetric Shocks in a Currency Union with Monetary and Fiscal Handcuffs
(with Christopher J. Erceg)

Abstract

This paper uses an open economy DSGE model to analyze how asymmetric shocks that are concentrated in a subset of member countries of a currency union affect the union both at an aggregate level, and differentially across member states. While this question has a long history in the optimal currency area literature, our framework takes explicit account of possible constraints on both monetary and fiscal policy. In particular, we assume that monetary policy is constrained by the zero lower bound (ZLB) on policy rates, and also consider the possibility that fiscal policy in at least some members may be constrained to react aggressively to debt or deficits.