
title: 'Monetary and Fiscal Policy Interaction in a Currency Union with Heterogeneous Agents'

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date: '2023-11-01T00:00:00Z' doi: "

Schedule page publish date (NOT publication's date).

publishDate: '2017-01-01T00:00:00Z'

Publication type.

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7 = Thesis; 8 = Patent

publication_types: ['7']

Publication name and optional abbreviated publication name.

publication:

publication_short: In /CW

abstract: How does household heterogeneity affect the transmission of macroeconomic shocks and the interaction of fiscal and monetary policy in a currency union? This paper develops a two-country New Keynesian model of a currency union with household heterogeneity. Member countries are subject to a union-wide monetary policy, but differ in the degree of households heterogeneity and feature sovereign fiscal authorities with counter-cyclical stabilization objectives. The framework provides novel evidence of changes in the response to shocks, both quantitatively and qualitatively, as well as profound policy implications and spillover effects when household heterogeneity is taken into account. The effects of monetary policy and cost-push shocks are significantly amplified. A union-wide productivity shock results in a pronounced economic boom requiring fiscal and monetary policy contractions. In stark contrast to the representative agents literature, a domestic fiscal policy shock has the effect of crowding in private consumption. The existence of Keynesian households in one country of the currency union also results in profound spillover effects to other countries transmitted through the trade of goods and a terms-of-trade channel. Countries with lower proportions of Keynesian households inherit the amplification caused by hand-to-mouth households in other countries. The magnitude of spillover effects tends to increase with the degree of trade openness of the economies.

Summary. An optional shortened abstract.

summary: This paper develops a two-country New Keynesian model of a currency union with households heterogeneity. Member countries are subject to a union-wide monetary policy, but differ in the degree of households heterogeneity and feature sovereign fiscal authorities with counter-cyclical stabilization objectives. The framework provides novel evidence of changes in the response to shocks, both quantitatively and qualitatively, as well as profound policy implications and spillover effects when household heterogeneity is taken into account.

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