Monetary Policy and Welfare in a Currency Union

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Abstract

I explore the welfare implications of currency union membership in a model that generates a trade-off between alternative monetary arrangements. While a national currency enables a country-specific stabilization of business cycles, a monetary union eliminates some trade frictions and transitory cross-border price misalignments caused by nominal rigidities. I quantify the welfare gap between these two arrangements and show that it depends crucially on the correlation of shocks across the countries involved. I estimate the model with data from eleven Eurozone members and I seek the minimum trade gains needed to make a single currency worthwhile for them. I find that modest trade gains are likely to be sufficient, given the good business-cycle affiliation of these economies over my sample.

JEL Classification: E42, E52, F41, F45

Currency union; Incomplete markets; Nominal rigidities; Local currency pricing; Trade frictions.

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