

Fragmented Monetary Unions

by Fornaro and Grosse-Steffen

Discussion by

Carlo Galli

UC3M and CEPR

32nd CEPR ESSIM

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The Paper in a Nutshell

- Self-fulfilling capital flows cause financial fragmentation (austerity & recession vs growth)
- Motivation repeatedly used by ECB to justify asset purchase policies
- $\approx$ cost-push shock: CB trades off output in periphery vs inflation in core
- “TPI” can restore symmetry by fiscal subsidies that crowd in capital (need flexibility + fiscal backing)

Beautiful paper!



Carlo Galli @carlogalli6 · Apr 8, 2024



Finally, someone wrote a theory about what "fragmentation risk" actually means, and why the ECB should be doing something about it



Luca Fornaro @LucaFornaro3 · Apr 8, 2024

New paper on Fragmented Monetary Unions.

We provide a theory to understand why fragmentation risk threatens price stability in the euro area, some monetary interventions by the ECB (OMT, PEPP, TPI), and why the ECB is not your usual central bank....

Fragmented Monetary Unions

Luca Fornaro and Christoph Grosse-Steffen*

April 2024

Abstract

We provide a theory of financial fragmentation in monetary unions. Our key insight is that currency unions may experience endogenous breakings of symmetry: that is episodes in which identical countries react differently when exposed to the same shock. During these events part

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implies

$$\tau_1^k = \frac{G[\dots] - \tau^l[\dots]f(k^*)(1 - \alpha(\tau_0^k))}{f(k^*(1 - \gamma(\tau_0^k)))}$$

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- higher $\tau_0^k \Rightarrow$ lower labour & capital tax bases $\Rightarrow$ higher τ_1^k
 - depending on G & parameters, 1 or multiple equilibria
- α : labour tax base through domestic demand (possibly not needed?)
- γ : capital tax base, direct effect
- both $\uparrow$ in capital mobility ϕ

Monetary Policy Implications

Conventional policy

- Given c_i^T , CB sets P^T to affect c_h^N via $P_i^N c_i^N = \frac{1-\omega}{\omega} c_i^T P^T$
- Downward wage rigidity: $L_i \leq \bar{L}$ vs $P_i^N = W_i \geq \bar{W}$

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Anti-fragmentation “transmission protection” policies

- Households need money to buy consumption basket $\approx$ consumption tax $M/P^T = \kappa C^T$

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Anti-fragmentation “transmission protection” policies

- Households need money to buy consumption basket $\approx$ consumption tax $M/P^T = \kappa C^T$
- Money issuance revenues flexibly rebated to countries
 - CB uses fiscal subsidies to undo capital flights
 - If optimal subsidy $> M/P^T$, fiscal backing is key

Comments

1. Interpretation and empirics
2. Source of multiplicity
3. Nature of unconventional monetary policy

1. Interpretation and Empirics

Paper implications

- Capital flight countries are the fiscally fragile (high debt, high spreads, high deficits)
- Model predicts MP responses of fragile countries big for GDP, small for CPI

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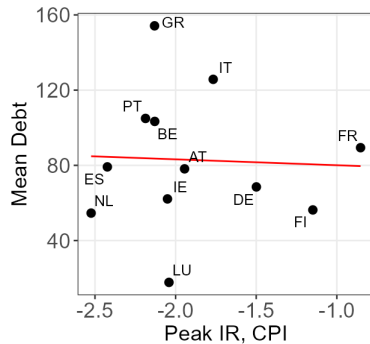
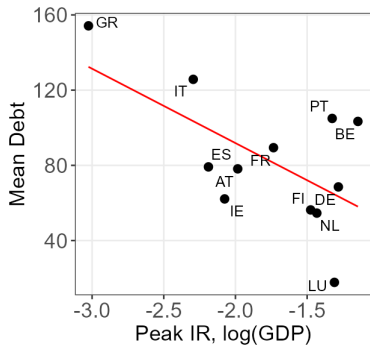
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Recent work with Caggiano, de Ferra, Rogantini-Picco

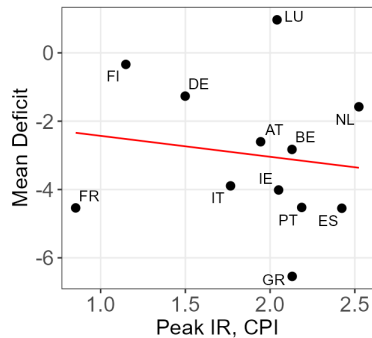
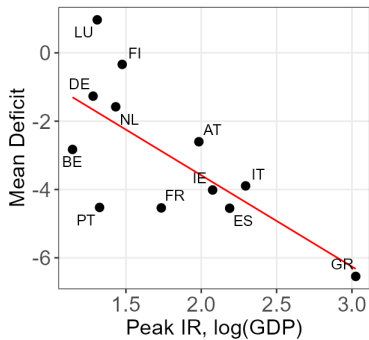
- Estimate LP-IV a la Ramey-Zubairy (2018), look at peak IR vs fiscal “fragility”

$$\Delta Y_{t+h} = \alpha_h + \beta_h \hat{i}_t + \mathbf{X}'_t \gamma_h + u_{t+h} \quad \text{with} \quad Y \in \{\log(GDP), \pi\}$$

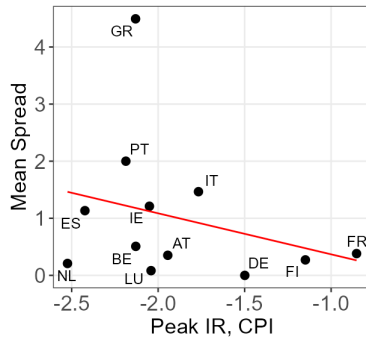
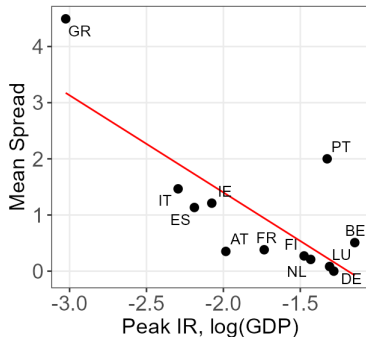
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- Alternative story: in fragile countries fiscal policy cannot counteract monetary policy

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 - responsiveness of primary balance and/or debt issuance
e.g.
 - bond market expects high default risk
 - require high interest rates, debt piles up (Calvo (1988), Lorenzoni-Werning (2019))
 - alternatively, govt does *austerity* instead of borrowing (Galli (2021))
 - future debt/GDP high, high spreads justified

3. Nature of Anti-Fragmentation Policies

Asset purchases in the model

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Asset purchases in practice

- intervention on spreads, when unwarranted by fundamentals
- swap of reserves for govt debt, no direct revenues generation
- $\approx$ debt service subsidy, to *all* sovereigns
- balance sheet profits & losses possible
- very large, arguably effective

Conclusion

Brilliant paper!

- Super important question, surprisingly unexplored given size of policy response
- Beautiful, tractable, clear model
- Important policy recommendations