

Financial Heterogeneity and Monetary Union

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Abstract

We analyze the economic consequences of forming a monetary union among countries with varying degrees of financial distortions, which interact with the firms' pricing decisions because of customer-market considerations. In response to a financial shock, firms in financially weak countries (the periphery) maintain cashflows by raising markups—in both domestic and export markets—while firms in financially strong countries (the core) reduce markups, undercutting their financially constrained competitors to gain market share. When the two regions are experiencing different shocks, common monetary policy results in a substantially higher macroeconomic volatility in the periphery, compared with a flexible exchange rate regime; this translates into a welfare loss for the union as a whole, with the loss borne entirely by the periphery. By helping firms from the core internalize the pecuniary externality engendered by the interaction of financial frictions and customer markets, a unilateral fiscal devaluation by the periphery can improve the union's overall welfare.

JEL CLASSIFICATION: E31, E32, F44, F45

KEYWORDS: eurozone; financial crisis; monetary union; inflation dynamics; markups; fiscal devaluation

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1 Introduction

The consensus in both the academic and policy circles is that the eurozone’s recent financial crisis was a classic balance-of-payment crisis, which can be traced to the toxic mix of excessive credit growth and loss of competitiveness in the euro area periphery. Following the introduction of the euro in early 1999, periphery countries such as Greece, Ireland, Italy, Spain, and Portugal went on a borrowing spree, the proceeds of which were used largely to finance domestic consumption and housing investment. Foreign investors’ widespread reassessment of risks during the 2008–2009 global financial crisis, along with a growing recognition of an unsustainable fiscal situation in Greece, precipitated a sharp pullback in private capital from the periphery in early 2010. This further tightening of financial conditions exacerbated the already painful process of deleveraging through which the periphery economies were attempting to bring domestic spending—both government and private—back into line with domestic incomes.¹

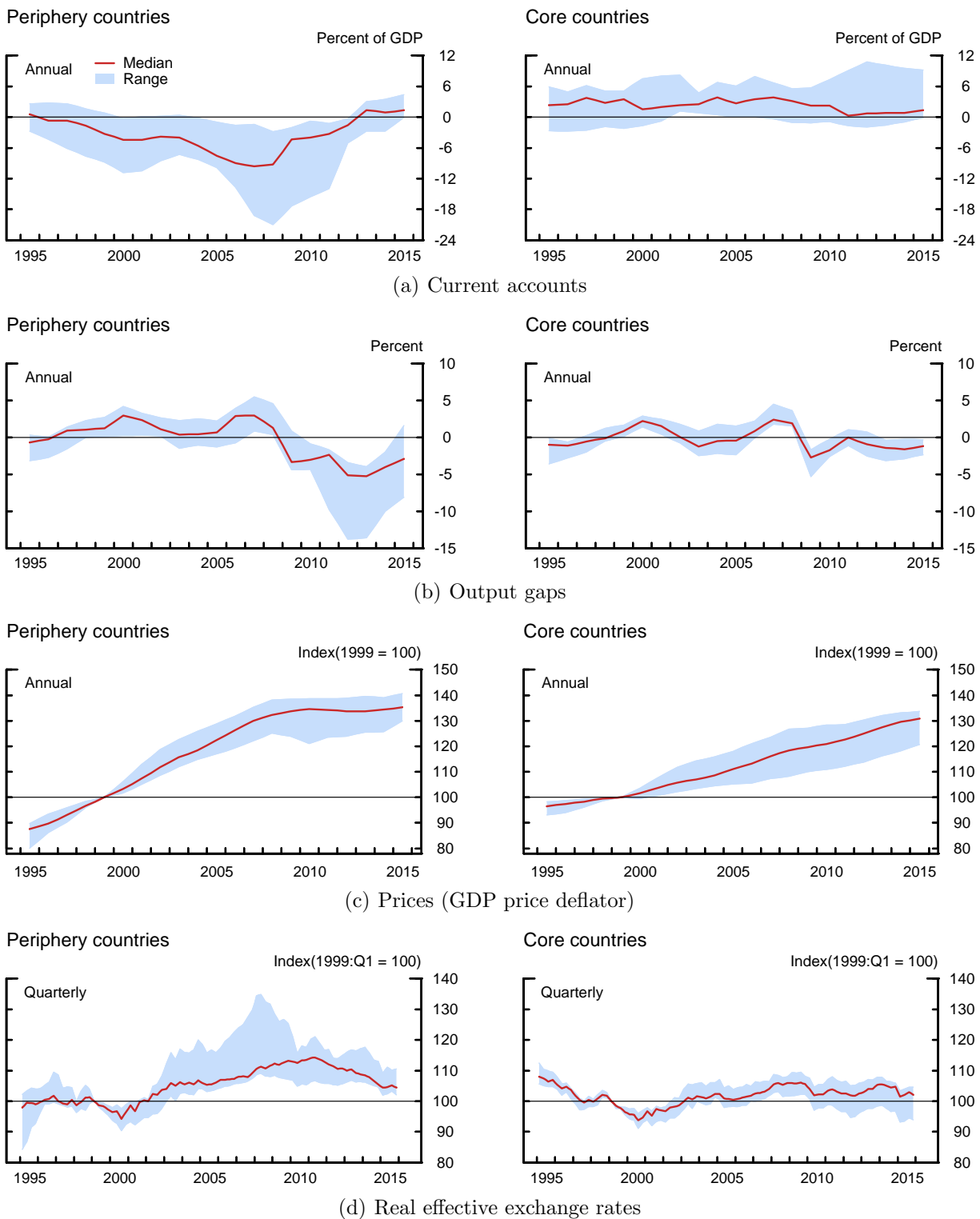
As shown in Figure 1, this narrative accords well with empirical evidence. The median current account deficit in the euro area periphery reached almost 10 percent of GDP on the eve of the global financial crisis, with some countries running current account deficits as high as 20 percent (panel (a)).² The next two panels provide evidence of overheating that led to the crisis: Between 1999 and 2007, periphery economies saw their real GDP growing persistently above potential, whereas their counterparts in the core registered a much more balanced pattern of economic growth (panel (b)). As a result, prices in the periphery increased at a much faster pace during this period compared with those in the core countries (panel (c)). Given these developments, real exchange rates in the periphery appreciated substantially (panel (d)), eroding these countries’ competitiveness and producing large trade deficits, which were easily financed by foreign capital inflows against the backdrop of the convergence in domestic interest rates across the euro area.

In a monetary union comprised of countries experiencing different economic and financial conditions—with limited labor mobility and no common fiscal policy—the financial crisis would have to be resolved largely through a downward adjustment of the overvalued real exchange rates in the periphery. In the euro area, however, this adjustment has occurred very slowly. Although the periphery has endured notable disinflation since 2010, an appreciable gap remains, on balance, between the general level of prices in the core and periphery. As a result, real effective exchange rates in the periphery have tended to remain above those of the core euro area countries.

¹As emphasized by [Auer \(2014\)](#), the tightening of financial conditions was not as severe as might have been expected given the scale of capital flight from the periphery. The withdrawal of capital was tempered importantly by cross-border credits to central banks in deficit countries, extended by other euro area central banks through the so-called TARGET2 system, a mechanism for managing payment imbalances among eurozone member countries. In combination with policies to supply liquidity to banks in the periphery, this balance of payments financing helped offset the drain of funds abroad.

²Throughout the paper, we use the following definition of the euro area core and periphery. Core countries: Austria, Belgium, Finland, France, Germany, and Netherlands. Periphery countries: Greece, Ireland, Italy, Portugal, and Spain. We omit the Eastern European countries (Estonia, Latvia, Lithuania, Slovakia, and Slovenia) from the periphery because they adopted the euro relatively recently. Our analysis also excludes Cyprus, Luxembourg, and Malta because of limited data in some instances and because of their very specialized economies. All told, our sample of countries accounts for about 95 percent of the eurozone’s total economic output.

FIGURE 1 – Selected Macroeconomic Indicators for the Euro Area (1995–2015)



NOTE: The solid lines depict the evolution of the cross-sectional median of the specified macroeconomic series, while the shaded bands denote the corresponding cross-sectional range. Periphery countries: Greece, Ireland, Italy, Portugal, and Spain. Core countries: Austria, Belgium, Finland, France, Germany, and Netherlands.

SOURCE: AMECO database (European Commission); and Bank for International Settlements.

What economic forces are responsible for such a slow adjustment in the price levels between the core and periphery countries? Why have firms in the periphery—given the degree of resource underutilization in these economies—been so slow to cut prices? By the same token, why have firms in the core been reluctant to increase prices, despite an improvement in the economic outlook and highly stimulative monetary policy? In fact, some prominent commentators have argued that it is the core countries that are exporting deflationary pressures into the periphery, a dynamic contrary to that needed to reverse the real exchange rate appreciation that has eroded the periphery’s competitiveness (see [Krugman, 2014](#)).

To help answer these questions, we build on [Gilchrist et al. \(2017\)](#), GSSZ hereafter, and introduce the interaction of customer markets and financial frictions into an otherwise standard international macroeconomic framework. Specifically, we augment the conventional two-country general equilibrium model with nominal rigidities and incomplete risk sharing with two new assumptions: First, we assume that firms operate in customer markets—both domestically and abroad.³ And second, we assume that foreign and domestic financial markets are subject to differing degrees of frictions. We then show that in such an environment firms from the core—that is, firms with a relatively unimpeded access to external finance—have a strong incentive to expand their market share at home and abroad by undercutting prices charged by their periphery competitors, especially when the latter are experiencing financial distress. By contrast, firms from the periphery have an incentive to increase markups in order to preserve internal liquidity, even though doing so means forfeiting some of their market share in the near term.

The idea that firms operating in customer markets and facing financial frictions set prices to actively manage current versus expected future demand is not new to macroeconomics (see [Gottfries, 1991](#); [Chevalier and Scharfstein, 1996](#)). Our contribution lies in bringing the interplay of customer markets and financial frictions into the international context and studying the implications of this interaction within a dynamic, two-country stochastic general equilibrium model. As we show below, this pricing mechanism generates time-varying markups and import price dynamics that differ significantly from those in the standard literature (see [Dornbusch, 1987](#); [Kimball, 1995](#); [Yang, 1997](#); [Bergin and Feenstra, 2001](#); [Atkeson and Burstein, 2008](#); [Gopinath and Itskhoki, 2010a,b](#); [Burstein and Gopinath, 2014](#); [Auer and Schoenle, 2016](#)). Specifically, this literature shows that following an adverse exchange rate shock, firms do not fully pass the resulting cost increase into import prices, but instead absorb some of this cost shock in their profits by *lowering* markups. In our model, by contrast, financially constrained firms, when hit by adverse shocks, try to maintain their cashflows by *increasing* markups in both the domestic and export markets, in effect trading off future market shares for current profits.

The interaction of customer markets and financial frictions helps explain several aspects of the eurozone financial crisis that are difficult to reconcile using conventional open-economy macro models. Most importantly, the pricing mechanism implied by this interaction is consistent with our

³By customer markets, we mean markets in which a customer base is “sticky” and thus an important determinant of firm’s assets and its ability to generate profits (see GSSZ for a thorough discussion).

empirical evidence, which shows that the acute tightening of financial conditions in the euro area periphery between 2008 and 2013 significantly attenuated the downward pressure on prices arising from the emergence of substantial and long-lasting economic slack. The tightening of financial conditions during this period is also strongly associated with an observed notable increase in markups in the periphery, which is exactly the pattern predicted by our model.

Our framework, therefore, can help explain why the periphery countries have managed to avoid a potentially devastating Fisherian debt-deflation spiral in the face of massive and persistent economic slack and high levels of indebtedness. It also helps us to understand the chronic stagnation in the euro area periphery and how the “price war” between the core and periphery has impeded the adjustment process through which the latter economies have been trying to regain external competitiveness. As such, the interaction of customer markets and financial frictions provides a complimentary economic mechanism to the recent work of [Schmitt-Grohé and Uribe \(2013, 2016\)](#), who emphasize the fact that nominal wages in the eurozone periphery failed to adjust downward after 2008 despite a significant increase in unemployment. In their model, a deflationary impetus emanating from the core countries that is engendered by our pricing mechanism further exacerbates the contractionary effects of an external financial shock in the periphery, as the latter economies face downwardly rigid nominal wages in a fixed exchange rate system.

In our model, the divergent economic trajectories between the core and periphery in response to a financial shock in the periphery present a dilemma for the union’s central bank because monetary policy cannot be targeted to just one region. Common monetary policy in a situation where members of the union are at different phases of the business cycle increases the volatility of consumption and hours worked in the periphery significantly above the levels registered under a flexible exchange rate regime. This translates into a welfare loss for the union as a whole, with the loss borne entirely by the periphery. The welfare in the core, by contrast, is higher in a monetary union despite an increase in macroeconomic volatility because the core’s average levels of output and market shares in the steady state are higher relative to those under flexible exchange rates.

With flexible exchange rates, in contrast, monetary authorities in the periphery are able to largely offset the real economic effects of an asymmetric financial shock by aggressively cutting policy rates, inducing a depreciation of nominal exchange rates in the periphery. And although the price levels between the core and periphery move in opposite directions because of customer-market considerations, the policy-induced currency devaluation can be sufficiently large to cause the real exchange rate to depreciate, thereby boosting exports of firms in the periphery and helping to stabilize the contraction in output. In a monetary union, this policy option is, of course, not available. The pricing behavior of firms in the core in response to an asymmetric financial shock in the periphery implies a real exchange rate depreciation vis-à-vis the periphery, which causes an export-driven boom in the core countries and a deepening of the recession in the periphery.

Given the union’s problem with a “one-size-fits-all” monetary policy, we consider the macroeconomic implications of a fiscal devaluation, a policy that has received considerable attention from academic economists and policymakers during the crisis. For example, [Adao et al. \(2009\)](#) and

Farhi et al. (2014) explore the stabilization properties of certain fiscal policy mixes, intended to replicate the effects of a nominal devaluation in a fixed exchange rate regime. What makes such policies desirable is the fact that they can be implemented unilaterally by the periphery countries encountering economic weakness. However, it is not clear why the core countries should welcome such unilateral policy interventions—in many instances, core countries have joined the monetary union precisely to avoid the manipulation of nominal exchange rates by the monetary authorities in the periphery.

Thus, a natural question that emerges is whether the periphery can carry out a unilateral fiscal devaluation without worrying about a retaliatory reaction from the core. We show that a fiscal devaluation by the periphery can be beneficial even to the core, provided that the aggregate demand externality generated by the international price war is not remedied by the union’s policymakers. In our framework, the pecuniary externality arises because firms in the core take aggregate prices and the real exchange rate as given when setting prices, and they do not take into account the effect of their pricing behavior on the union-wide aggregate demand. As shown theoretically by Farhi and Werning (2016), a distortionary taxation can help agents internalize such externalities, and in our model, fiscal devaluations provide an effective means of achieving this goal.

2 Financial Conditions, Prices, Wages, and Markups

In this section, we document how financial conditions influenced the dynamics of prices, wages, and markups in the eurozone periphery during the 2008–2013 period. We begin by examining the extent to which price and wage inflation forecast errors implied by the canonical Phillips curve relationships during this period are systematically related to differences in the tightness of financial conditions across countries. We do so in two steps. First, we use our panel of 11 euro area countries to estimate the following two Phillips curve specifications:

$$\pi_{it} = \alpha_i + \rho\pi_{i,t-1} + \lambda(u_{it} - \bar{u}_{it}) + \phi\Delta\text{VAT}_{it} + \psi\mathbf{1}[i \in \text{€}] + \epsilon_{it}; \quad (1)$$

$$\pi_{it}^w = \alpha_i + \rho\pi_{i,t-1} + \lambda(u_{it} - \bar{u}_{it}) + \phi\Delta\tilde{z}_{it} + \psi\mathbf{1}[i \in \text{€}] + \epsilon_{it}, \quad (2)$$

where i indexes countries and t represents time (in years). In terms of notation, π_{it} denotes price inflation measured by the log-difference of the GDP price deflator, while π_{it}^w denotes wage inflation measured by the log-difference of nominal compensation per employee. These two specifications are the textbook price and wage Phillips curves, which assume that inflation expectations are proportional to past inflation and where labor market tightness—measured by the difference of the unemployment rate u_{it} from its corresponding natural rate \bar{u}_{it} —is a fundamental determinant of price and wage dynamics.⁴

Although Phillips curves (1) and (2) tend to fit the data quite well, their theoretical shortcoming involves the assumptions of backward-looking inflation expectations. Accordingly, we also consider

⁴The wage Phillips curve (2) also includes the growth rate of trend labor productivity—denoted by $\Delta\tilde{z}_{it}$ —thereby allowing for a link between real wage bargaining and labor productivity (see Blanchard and Katz, 1999).

TABLE 1 – Price and Wage Phillips Curves in the Euro Area

Explanatory Variables	Prices ^a			Wages ^b	
	(1)	(2)	(3)	(4)	(5)
$(u_{it} - \bar{u}_{it})$	-0.273 (0.117)	-0.529 (0.127)	.	-0.559 (0.096)	-0.659 (0.118)
$(y_{it} - \bar{y}_{it})$	.	.	0.134 (0.084)	.	.
$\pi_{i,t-1}$	0.845 (0.046)	0.813 (0.046)	0.561 (0.078)	0.763 (0.057)	0.745 (0.050)
$E_t \pi_{i,t+1}$	.	.	0.407 (0.085)	.	.
$\Delta \tilde{z}_{it}$	.	.	.	0.689 (0.127)	0.668 (0.104)
ΔVAT_{it}	0.091 (0.040)	0.072 (0.039)	0.035 (0.057)	.	.
$\mathbf{1}[i \in \text{€}]$	-0.631 (0.300)	-0.657 (0.298)	-0.315 (0.202)	-1.529 (0.358)	-1.230 (0.286)
Adj. R^2	0.839	0.845	.	0.858	0.872
Pr > J^c	.	.	0.109	.	.
Equal coeff. on $(u_{it} - \bar{u}_{it})^d$	.	<.001	.	.	<.001

NOTE: In columns (1), (2), and (3), the dependent variable is π_{it} , the log-difference of the GDP price deflator of country i from year $t - 1$ to year t ; in columns (4) and (5), the dependent variable is π_{it}^w , the log-difference of (nominal) compensation per employee of country i from year $t - 1$ to year t . Explanatory variables: $(u_{it} - \bar{u}_{it})$ = unemployment gap; $(y_{it} - \bar{y}_{it})$ = output gap; $\Delta \tilde{z}_{it}$ = growth rate of trend labor productivity; VAT_{it} = effective VAT rate; and $\mathbf{1}[i \in \text{€}]$ = indicator variable that equals 1 once country i joined the eurozone. All specifications include country fixed effects; those in columns (1), (2), (4), and (5) are estimated by OLS, while the specification in column (3) is estimated by GMM. In columns (2) and (5), the coefficients on the unemployment gap are allowed to differ across countries, and the entries correspond to the average of the estimated OLS coefficients across the 11 countries. Asymptotic standard errors reported in parentheses are clustered in the time (t) dimension.

^a Sample period: annual data: from 1970 to 2007 ($\bar{T} = 29.7$); No. of countries = 11; Obs. = 327.

^b Sample period: annual data: 1971 to 2007 ($\bar{T} = 26.1$); No. of countries = 11; Obs. = 287.

^c p -value for the Hansen (1982) J -test of the over-identifying restrictions.

^d p -value for the test of equality of country-specific coefficients on $(u_{it} - \bar{u}_{it})$.

a New Keynesian variant of the Phillips curve (NKPC), which incorporates into the process of price inflation determination both rational expectations as well as more explicit microfoundations (see Galí and Gertler, 2000; Galí et al., 2001). In that case, we estimate,

$$\pi_{it} = \alpha_i + \beta_f E_t \pi_{i,t+1} + \beta_b \pi_{i,t-1} + \lambda \widehat{m}c_{it} + \phi \Delta \text{VAT}_{it} + \psi \mathbf{1}[i \in \text{€}] + \epsilon_{it}, \quad (3)$$

where $\widehat{m}c_{it}$ denotes a proxy for marginal cost. In addition to a country fixed effect α_i , all three specifications also include $\mathbf{1}[i \in \text{€}]$, an indicator variable that equals one when country i adopts the euro and thereafter; specifications (1) and (3) also control for the pass-through of changes in the effective value-added tax (VAT) rate to aggregate price inflation.

To ensure that the parameter estimates are not unduly influenced by the extraordinary events

surrounding the eurozone crisis, we end the estimation in 2007, that is, well before the onset of the crisis in the euro area.⁵ In columns (1) and (4) of Table 1, we report estimates of the coefficients of the standard price and wage Phillips curves, respectively; in columns (2) and (5), we repeat the same exercise, except that we allow the coefficients on the unemployment gap ($u_{it} - \bar{u}_{it}$) to differ across countries. And lastly, column (3) reports coefficient estimates of the NKPC with common coefficients, using the output gap ($y_{it} - \bar{y}_{it}$) as a proxy for marginal cost.⁶

As shown in columns (1), (2), (4), and (5), the degree of labor market slack is an economically and statistically important determinant of price and wage inflation dynamics in all four standard Phillips curve specifications. The estimated sensitivity of both price and wage inflation to tightness of labor market conditions is, on average, somewhat higher in specifications (2) and (5), which allow for a greater degree of heterogeneity in the price and wage inflation processes across countries. All four specifications, however, explain about the same proportion of the variability in annual price and wage inflation rates across our sample of 11 euro area countries.

The estimates of the NKPC in column (3) also indicate an economically significant effect of the output gap—our proxy for marginal cost—on inflation outcomes. This effect, however, is estimated with considerably less precision, compared with the estimated sensitivity of inflation to labor market slack implied by the standard Phillips curve specifications. The estimated NKPC assigns a significant role to the forward-looking component of the euro area inflation, though the inflation processes are also characterized by substantial inertial behavior, a result consistent with that of [Benigno and López-Salido \(2006\)](#).

As noted above, our interest is not in these estimates per se. Rather, we are interested in whether deviations of actual price and wage inflation from the trajectories implied by these Phillips curves during the crisis are systematically related to differences in the tightness of financial conditions across countries. To test this hypothesis, we use spreads on sovereign credit default swap (CDS) contracts to measure the degree of financial strains in each country.⁷ As emphasized by [Lane \(2012\)](#), the European sovereign debt crisis originated over concerns related to the solvency of national banking systems in the periphery. Accordingly, sovereign CDS spreads likely provide an accurate gauge of pressures faced by the national banking systems in the eurozone during the crisis. Given the bank-centric nature of the euro area, variation in CDS spreads should thus reflect differences in the tightness of financial conditions faced by businesses and households in different countries.⁸

Figure 2 shows the evolution of sovereign CDS spreads in the euro area from 2006 to 2015.

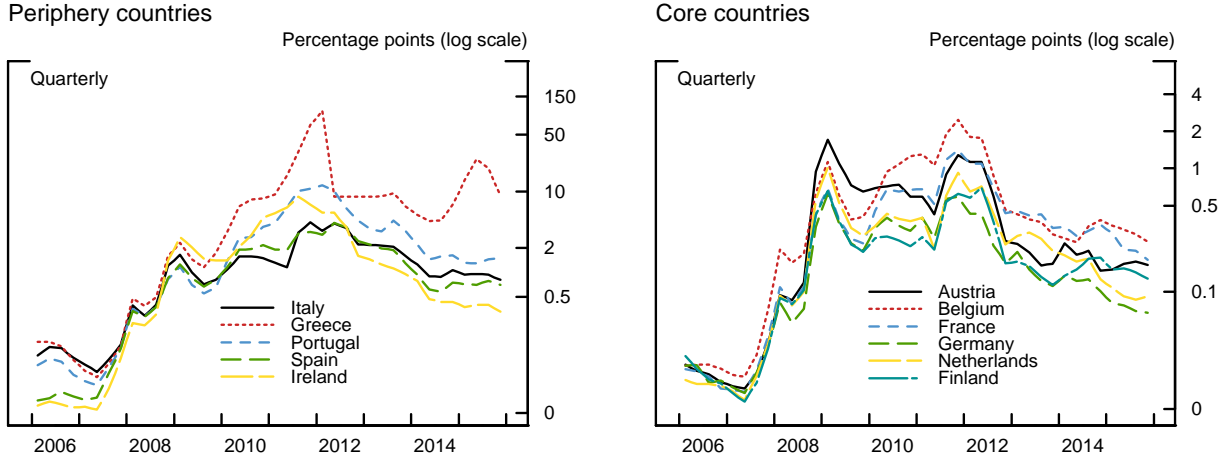
⁵All data, including the estimates of the natural rate of unemployment and potential GDP, come from the AMECO databases maintained by the European Commission. We estimate trend labor productivity (z_{it}) by regressing the log of labor productivity on a constant and a third-order polynomial in time.

⁶Specifications (1), (2), (4), and (5) are estimated by OLS; in the case of specifications (2) and (5), we report the average of the coefficient on the unemployment gap across the 11 countries in our panel. The NKPC is estimated by GMM, treating ($y_{it} - \bar{y}_{it}$) and $E_t\pi_{i,t+1}$ as endogenous and instrumented with lags 1 to 3 of ($y_{it} - \bar{y}_{it}$) and π_{it} , and lags 0 to 2 of the log-difference of commodity prices.

⁷We use premiums implied by the 5-year, euro-denominated contracts because they are the most liquid segment of the credit derivatives market.

⁸This assumption is consistent with the empirical evidence of [Neumeier and Perri \(2005\)](#) and [Uribe and Yue \(2006\)](#), who show that country interest rate shocks are an important driver of business cycles in emerging economies.

FIGURE 2 – Sovereign CDS Spreads in the Euro Area (2006–2015)



NOTE: The figure depicts sovereign (5-year) CDS spreads on euro-denominated contracts; each series is a quarterly average of the daily quotes.

SOURCE: Markit.

Clearly evident is the tightening of financial conditions in the eurozone periphery (left panel): First in 2008, as the escalating financial turmoil in the U.S. led to investors’ widespread reassessment of risks globally; and then again in 2010, when a growing recognition of an unsustainable fiscal situation in Greece led to a massive outflow of private capital from the periphery. To stabilize the economic and political situation that was spiraling out of control, EU leaders and the ECB responded in early 2012 with a number of aggressive policy measures, and by the end of 2013, the risk of financial contagion that investors thought would have likely led to a break-up of the eurozone receded notably.

To gauge the effects of these financial strains on price and wage dynamics, we first use the estimates in Table 1 to generate price and wage inflation prediction errors from 2008 to 2013. In the second step, we estimate the following regression:

$$\hat{\epsilon}_{it} = \theta_0 + \theta_1 \ln \text{CDS}_{i,t-1} + \theta_2 \ln \text{CDS}_{i,t-1} \times \mathbf{1}[i \in P] + \chi \mathbf{1}[i \in P] + u_{it}, \quad (4)$$

where $\hat{\epsilon}_{it}$ denotes a residual from one of the estimated Phillips curves in Table 1 and $\mathbf{1}[i \in P]$ is an indicator variable that equals one if country i is in the periphery and zero otherwise.⁹ The parameters θ_1 and θ_2 thus measure the extent to which differences in financial conditions between the core and periphery countries during the crisis can explain deviations of price and wage inflation trajectories from those implied by the various Phillips curve specifications.

⁹We estimate equation (4) by OLS. However, the associated statistical inference that relies on the usual asymptotic arguments is likely to be unreliable, given a relatively small number of observations, especially in the time-series dimension. Accordingly, we report the 95-percent confidence intervals for coefficients θ_1 and θ_2 , based on the time-clustered wild bootstrap procedure of Cameron et al. (2008), which is designed for situations in which the number of clusters or the number of observations within each cluster is relatively small.

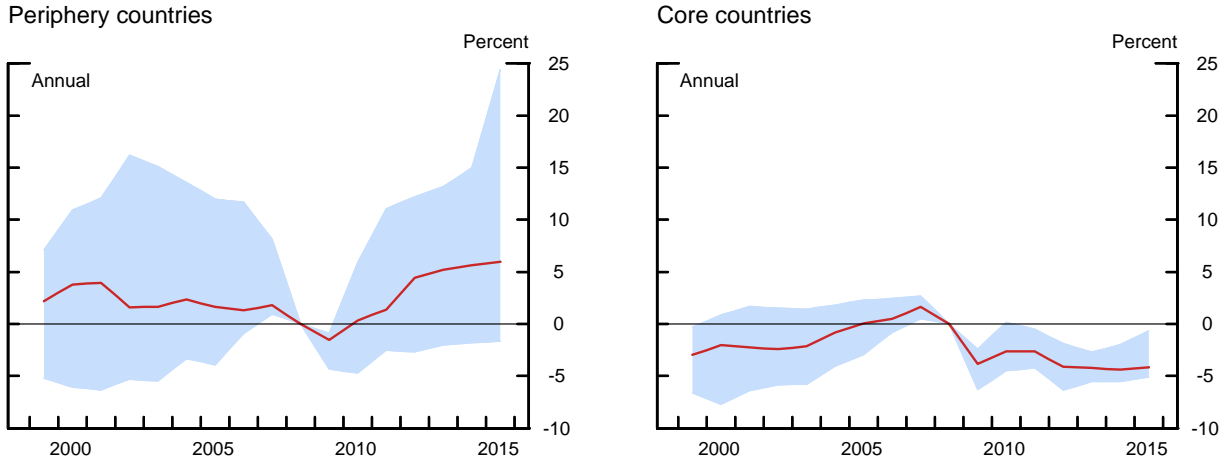
TABLE 2 – Financial Conditions and Phillips Curve Prediction Errors

PC Specification	Explanatory Variable		R^2
	$\ln \text{CDS}_{i,t-1}$	$\ln \text{CDS}_{i,t-1} \times \mathbf{1}[i \in \text{P}]$	
<i>(a) Without time fixed effects</i>			
1. Prices (homogeneous)	0.043 [−0.139, 0.227]	0.601 [0.218, 0.985]	0.198
2. Prices (heterogeneous)	0.204 [0.028, 0.372]	0.593 [0.156, 1.030]	0.258
3. Hybrid NK	0.028 [−0.100, 0.156]	0.299 [0.022, 0.577]	0.110
4. Wages (homogeneous)	−0.008 [−0.266, 0.251]	−0.776 [−1.425, 0.100]	0.254
5. Wages (heterogeneous)	0.085 [−0.190, 0.360]	−2.075 [−3.082, −1.069]	0.425
<i>(b) With time fixed effects</i>			
1. Prices (homogeneous)	0.044 [−0.239, 0.327]	0.453 [0.092, 0.814]	0.329
2. Prices (heterogeneous)	0.684 [0.369, 0.999]	0.275 [0.031, 0.519]	0.419
3. Hybrid NK	0.125 [−0.051, 0.301]	0.200 [−0.031, 0.410]	0.205
4. Wages (homogeneous)	−1.364 [−2.221, −0.506]	−0.495 [−1.359, 0.369]	0.352
5. Wages (heterogeneous)	−2.196 [−2.731, −1.661]	−1.469 [−2.550, −0.389]	0.542

NOTE: Sample period: annual data from 2008 to 2013; No. of countries = 11; Obs. = 66. The dependent variable is $\hat{\epsilon}_{it}$, a price or wage inflation prediction error of country i in year t implied by the specified Phillips curve. Homogeneous Phillips curve specifications impose the same coefficient on the unemployment gap, whereas in heterogeneous specifications, the coefficient on the unemployment gap is country specific (see the text and notes to Table 1 for details). The entries denote the OLS estimates of the coefficients associated with the log-level of sovereign (5-year) CDS spreads at the end of year $t - 1$. All specifications include a constant and $\mathbf{1}[i \in \text{P}]$, an indicator for whether country i is in the euro area periphery (not reported). The 95-percent confidence intervals reported in brackets are based on the empirical distribution of coefficients across 5,000 replications, using the wild bootstrap clustered in the time (t) dimension (see Cameron et al., 2008).

As shown in panel (a) of Table 2, differences in financial conditions across the euro area during this period are systematically related to the deviations of price and wage inflation from the dynamics implied by canonical Phillips curve-type relationships. Turning first to prices (rows 1, 2, and 3), the positive estimates of θ_2 , the coefficient on the interaction term $\ln \text{CDS}_{i,t-1} \times \mathbf{1}[i \in \text{P}]$, imply that a widening of sovereign CDS spreads in the eurozone periphery is associated with subsequent inflation rates that exceed those predicted by our various estimated Phillips curves. With regards to wages (rows 4 and 5), on the other hand, negative estimates of θ_2 imply that increased sovereign risk in the periphery leads to subsequent wage growth that is below that predicted by the estimated Phillips curves. The 95-percent confidence intervals bracketing the point estimates of θ_2 exclude zero, an indication that these relationships are statistically significant at conventional levels. For

FIGURE 3 – Price Markups in the Euro Area (1999–2015)



NOTE: The solid lines depict the cross-sectional median of price markups, while the shaded bands denote the corresponding cross-sectional range. The price markup is defined as minus (100 times) the log of real unit labor costs (2008 = 1). Periphery countries: Greece, Ireland, Italy, Portugal, and Spain. Core countries: Austria, Belgium, Finland, France, Germany, and Netherlands.
SOURCE: AMECO database.

the core euro area countries, by contrast, there appears to be no systematic relationship between sovereign credit risk and Phillips curve prediction errors.

In panel (b), we repeat the same exercise, except we add time fixed effects to specification (4)—hence, the parameters θ_1 and θ_2 are identified using only variation between countries. As before, the results indicate that an increase in sovereign CDS spreads in the eurozone periphery is associated with rates of price inflation that lie systematically above those predicted by the estimated Phillips curves, whereas such tightening of credit conditions leads to rates of wage inflation that run systematically below those implied by the corresponding estimated wage Phillips curve. Taken together, these findings indicate that the deterioration in financial conditions may have significantly influenced the behavior of markups in the periphery.

Figure 3 shows the evolution of price markups in the eurozone periphery (left panel) and in the core countries (right panel) since the introduction of the euro in 1999.¹⁰ The divergence in markups between the core and periphery during the crisis is striking: The median markup in the periphery increased about 5 percentage points between 2009 and 2013, while in the core, the median markup fell about the same amount during this period. To examine how differences in financial strains across countries affected the behavior of markups in the euro area during the crisis, we re-estimate regression (4) using the change in price markups as the dependent variable.

As indicated in panel (a) of Table 3, a widening CDS spreads in the periphery is associated with a statistically significant subsequent increase in markups, whereas in the euro area core, such a tightening of financial conditions has no effect on markups; note that this effect is robust to the

¹⁰As shown by Galí et al. (2007), the price markup can, under reasonable assumptions, be measured (up to an additive constant) as minus the log of real unit labor costs.

TABLE 3 – Financial Conditions and Price Markups

Specification	Explanatory Variable		R^2
	$\ln \text{CDS}_{i,t-1}$	$\ln \text{CDS}_{i,t-1} \times \mathbf{1}[i \in \text{P}]$	
(a) <i>Aggregate markups</i> ^a			
1. Without time fixed effects	−0.205 [−0.944, 0.534]	1.378 [0.557, 2.220]	0.256
2. With time fixed effects	−0.312 [−0.528, −0.095]	1.148 [0.926, 1.372]	0.681
(b) <i>Sectoral markups</i> ^b			
1. Without time fixed effects	−0.442 [−2.135, 1.252]	2.556 [0.913, 4.198]	0.057
2. With time fixed effects	−0.331 [−1.915, 1.254]	1.974 [1.244, 2.704]	0.152

NOTE: In panel (a), the dependent variable is the change in the aggregate price markup in country i from year $t - 1$ to year t , while in panel (b) the dependent variable is the change in the country-specific sectoral price markup over the same period. The entries denote the OLS estimates of the coefficients associated with the log-level of sovereign (5-year) CDS spreads at the end of year $t - 1$. All specifications include a constant and $\mathbf{1}[i \in \text{P}]$, an indicator for whether country i is in the euro area periphery (not reported); specifications in panel (b) also include sector fixed effects. The 95-percent confidence intervals reported in brackets are based on the empirical distribution of coefficients across 5,000 replications, using the wild bootstrap clustered in the time (t) dimension (see [Cameron et al., 2008](#)).

^a Sample period: annual data from 2008 to 2013; No. of countries = 11; Obs. = 66.

^b Sample period: annual data from 2008 to 2013; No. of countries = 11; No. of sectors = 5; Obs. = 328.

inclusion of time fixed effects. In panel (b), we improve on the power of this test by considering changes in markups at the sectoral level.¹¹ Adding this dimension to our data further strengthens the relationship between financial conditions and subsequent changes in price markups. Using the “between” estimates in row 2 as a benchmark, a periphery country with CDS spreads at the 90th percentile of the distribution would see its markups increase more than 5.5 percentage points, compared with a country whose CDS spreads are at the 10th percentile of the distribution.

In sum, the above results add to the growing empirical evidence, which strongly supports the notion that financial conditions of firms in the euro area affected their pricing decisions during the global financial crisis and its aftermath (see [Montero and Urtasun, 2014](#); [Antoun de Almedia, 2015](#); [Montero, 2017](#); [Duca et al., 2017](#)). As we show below, combining the theory of customer markets with financial frictions provides a natural way to understand these new findings. The pricing mechanism implied by this interaction predicts exactly the differences in the behavior of prices and markups between the eurozone core and periphery documented above: In response to a financial shock in the periphery, the tightening of credit conditions causes firms—in an effort to preserve internal liquidity—to boost prices by raising markups. The following quote from Sergio Marchionne, the CEO of Fiat Chrysler, in mid-2012 paints a visceral picture of the price dynamics

¹¹For each country in our sample, the AMECO data base contains real unit labor costs for the following five sectors: (1) Agriculture, Forestry & Fishing; (2) Building & Construction; (3) Industry (excl. Building & Construction); (4) Manufacturing; and (5) Services.

implied by our theory:

Mr. Marchionne and other auto executives accuse Volkswagen of exploiting the crisis to gain market share by offering aggressive discounts. “It’s a bloodbath of pricing and it’s a bloodbath on margins,” he said.

The New York Times, July 25, 2012

3 Model

The model consists of two countries—referred to as home (h) and foreign (f)—and where foreign country variables carry a superscript “*.” We think of home and foreign countries as representing the periphery and core countries of the euro area, respectively.

3.1 Preferences and Technology

In each country, there exists a continuum of households indexed by $j \in N_c = [0, 1]$, $c = h, f$. Each household consumes two types, h and f , of differentiated varieties of consumption goods, indexed by $i \in N_h = [0, 1]$ in the home country and by $i \in N_f = [1, 2]$ in the foreign country. Consistent with the standard assumption used in international macroeconomics, the home country only produces the h -type goods, while the foreign country only produces the f -type goods. In this two-country setting, $c_{i,f,t}^j$ denotes the consumption of product i of type f by a home country household j , while $c_{i,f,t}^{j*}$ denotes its foreign counterpart—that is, the consumption of product i of type f by a foreign country household j .¹²

The preferences of household j in the home country are given by

$$\mathbb{E}_t \sum_{s=0}^{\infty} \delta^s U(x_{t+s}^j - \omega_{t+s}, h_{t+s}^j); \quad (0 < \delta < 1). \quad (5)$$

The household’s per-period utility function $U(\cdot, \cdot)$ is strictly increasing and concave in the consumption bundle x_t^j and strictly decreasing and concave in hours worked h_t^j . The preference shock ω_t affects the marginal utility of consuming the bundle x_t^j today and is used to explore the implications of an aggregate demand shock in our framework. For simplicity, we assume that labor is perfectly immobile.

Standard open economy models allow for home-bias in consumption by combining Dixit-Stiglitz preferences with an Armington aggregator of home and foreign goods. We introduce into this framework a sticky customer base via the “deep habits” preference structure of [Ravn et al. \(2006\)](#). This yields the consumption/habit aggregator

$$x_t^j \equiv \left[\sum_{k=h,f} \Xi_k \left[\int_{N_k} (c_{i,k,t}^j / s_{i,k,t}^\theta)^{1-1/\eta} di \right]^{\frac{1-1/\varepsilon}{1-1/\eta}} \right]^{\frac{1}{1-1/\varepsilon}},$$

¹²In our notation, $c_{i,f,t}^j$ denotes consumption of an imported good by a home country household j , while $c_{i,f,t}^{j*}$ denotes consumption of a domestically produced good by a foreign household j .

where $\eta > 1$ and $\varepsilon > 1$ are the elasticities of substitution *within* a type of goods produced in a given country and *between* the two types of goods, respectively. The parameter $\Xi_k > 0$ governs the degree of home bias in the household's consumption basket in the steady state, with $\sum_{k=h,f} \Xi_k^\varepsilon = 1$.

Let $c_{i,k,t} = \int_0^1 c_{i,k,t}^j dj$ denote the average level of consumption of good i in country k . As in [Ravn et al. \(2006\)](#), let $s_{i,k,t}$ denote the *good-specific* habit, which evolves according to

$$s_{i,k,t} = \rho s_{i,k,t-1} + (1 - \rho)c_{i,k,t}; \quad k = h, f \quad (0 < \rho < 1). \quad (6)$$

In above formulation, habits are external to the household and country specific.¹³ When $\theta < 0$, the stock of habit formed by past consumption of the average household has a positive effect on the utility derived from today's consumption, making the household desire more of the same good. This creates an incentive for firms to lower prices in order to build customer base.

In equilibrium, all households within a given country choose the same consumption basket. Going forward, we thus omit the household index j . The cost minimization associated with equation (5) implies the following demand function for good i (of type h or f) in the home country:

$$c_{i,k,t} = \left(\frac{P_{i,k,t}}{\tilde{P}_{k,t}} \right)^{-\eta} s_{i,k,t-1}^{\theta(1-\eta)} x_{k,t}; \quad k = h, f, \quad (7)$$

where the habit-adjusted price index $\tilde{P}_{k,t}$ and the habit-adjusted consumption bundle $x_{k,t}$ are given by

$$\tilde{P}_{k,t} = \left[\int_{N_k} (P_{i,k,t} s_{i,k,t-1}^\theta)^{1-\eta} di \right]^{\frac{1}{1-\eta}} \quad \text{and} \quad x_{k,t} = \left[\int_{N_k} (c_{i,k,t} / s_{i,k,t-1}^\theta)^{1-1/\eta} di \right]^{\frac{1}{1-1/\eta}}; \quad k = h, f.$$

In equilibrium, the consumption/habit basket $x_{k,t}$ is equal to

$$x_{k,t} = \Xi_k^\varepsilon \left(\frac{\tilde{P}_{k,t}}{\tilde{P}_t} \right)^{-\varepsilon} x_t; \quad k = h, f, \quad \text{with} \quad \tilde{P}_t = \left[\sum_{k=h,f} \Xi_k \tilde{P}_{k,t}^{1-\varepsilon} \right]^{\frac{1}{1-\varepsilon}}, \quad (8)$$

where \tilde{P}_t denotes the welfare-based aggregate price index of the home country. Due to the symmetric structure of the two countries, the foreign country analogues of $c_{i,k,t}$, $x_{k,t}$, and \tilde{P}_t can be expressed simply by adding a superscript “*” to each variable. For later use, we also define the consumer price index (CPI) as

$$P_t = \left[\sum_{k=h,f} \Xi_k P_{k,t}^{1-\varepsilon} \right]^{\frac{1}{1-\varepsilon}}, \quad \text{where} \quad P_{k,t} = \left[\int_{N_k} P_{i,k,t}^{1-\eta} di \right]^{\frac{1}{1-\eta}}; \quad k = h, f, \quad (9)$$

¹³Because of external habits, households take the habit stock as given and do not internalize the effect of their own consumption on future demand; see [Nakamura and Steinsson \(2011\)](#) for the analysis of firms' pricing-setting behavior implied by good-specific internal habits. It is also worth noting that [Gottfries \(1991\)](#) derives an expression similar to equation (6) in the context of product switching costs.

is the CPI corresponding to a k -type category of goods.¹⁴

The production technologies in the home and foreign countries are given by

$$y_{i,t} = \left(\frac{A_t}{a_{i,t}} h_{i,t} \right)^\alpha - \phi \quad \text{and} \quad y_{i,t}^* = \left(\frac{A_t^*}{a_{i,t}^*} h_{i,t}^* \right)^\alpha - \phi^*; \quad (0 < \alpha \leq 1),$$

where $\phi, \phi^* > 0$ denote fixed operating costs, which in principle can differ between the two countries; A_t and A_t^* are the country-specific aggregate technology shocks, and $a_{i,t}$ and $a_{i,t}^*$ are the idiosyncratic “cost” shocks affecting home and foreign firms, respectively. We assume that the idiosyncratic cost shocks are distributed according to a log-normal distribution: $\ln a_{i,t}, \ln a_{i,t}^* \stackrel{iid}{\sim} N(-0.5\sigma^2, \sigma^2)$. We denote the CDF of the idiosyncratic shocks by $F(a)$. The presence of fixed costs makes it possible for firms to incur operating losses and hence find themselves in a liquidity squeeze if external financing is costly or, as during the height of the eurozone sovereign debt crisis, essentially unavailable.

3.2 Frictions

For fixed costs to play a role in creating liquidity risk, we introduce several frictions to the firm’s flow-of-funds constraint. First, we adopt a timing convention, whereby in the first half of period t firms collect information about the aggregate state of the economy. Based on this aggregate information, firms post prices, take orders from customers, and plan production based on *expected* marginal cost. In the second half of the period, idiosyncratic cost uncertainty is resolved, and firms realize their *actual* marginal cost. They then hire labor to fulfill the agreed-upon orders and produce period- t output.

We also assume that firms pay out all operating profits as dividends within a given period—that is, we rule out corporate savings.¹⁵ Because of fixed costs, the firm’s revenues may, ex post, be insufficient to cover the total cost of production. In that case, the firm must issue new shares within that period. Due to agency problems, such equity financing involves a constant dilution cost per share issued, denoted by $0 < \varphi, \varphi^* < 1$. Hence when a home country firm issues a notional amount of equity $d_{i,t} < 0$, the actual amount of funds raised is given by $-(1 - \varphi)d_{i,t}$. Consistent with the fact that core euro area countries have deeper and more developed capital markets than the eurozone periphery, the dilution costs in the home country are assumed to exceed those in foreign country—that is, $0 < \varphi^* < \varphi$. This implies that firms in the home country are more exposed to liquidity risk than their foreign counterparts.¹⁶

In addition to financial frictions, we also allow for nominal rigidities by assuming that firms

¹⁴See the Online Technical Appendix for the derivation of equations (7)–(9).

¹⁵Ruling out precautionary savings limits the dimension of the state space. However, this assumption does not mean that firms do not engage in any form of risk management. Rather, as shown below, the firms’ liquidity risk management involves the accumulation and decumulation of market shares, a central facet of their pricing behavior.

¹⁶An implicit assumption of our setup is that the equity markets of the two countries are fully segmented—only domestic (foreign) households invest in the shares of domestic (foreign) firms. Empirical evidence of significant home bias in equity holdings is provided by French and Poterba (1991), Tesar and Werner (1995), and Obstfeld and Rogoff (2000).

incur costs when adjusting prices. Following Rotemberg (1982), these costs are given by

$$\frac{\gamma_p}{2} \left(\frac{P_{i,h,t}}{P_{i,h,t-1}} - 1 \right)^2 c_t + \frac{\gamma_p}{2} \frac{Q_t P_t^*}{P_t} \left(\frac{P_{i,h,t}^*}{P_{i,h,t-1}^*} - 1 \right)^2 c_t^*; \quad (\gamma_p > 0),$$

where Q_t denotes the nominal exchange rate. We assume the same degree of price stickiness (γ_p) in both countries and let the price adjustment costs be proportional to local consumption—that is, c_t and c_t^* —an assumption made solely to preserve the homogeneity of the firm’s problem and one that has no first-order consequences for dynamics of the model. Note also that we assume local currency pricing rather than producer currency pricing.

3.3 The Firm’s Problem

The firm’s objective is to maximize the present value of its dividend flow, $\mathbb{E}_t \left[\sum_{s=0}^{\infty} m_{t,t+s} d_{i,t+s} \right]$, where $d_{i,t} = D_{i,t}/P_t$ is the real dividend payout when positive and real equity issuance when negative. Firms are owned by households, and they discount future cashflows using the stochastic discount factor of the representative household, denoted by $m_{t,t+s}$, in their respective country. Before formally stating the firm’s optimization problem, we define relative prices. The real product prices relative to the CPIs in home and foreign countries can be written as

$$\frac{P_{i,h,t}}{P_t} = \frac{P_{i,h,t}}{P_{h,t}} \frac{P_{h,t}}{P_t} \equiv p_{i,h,t} p_{h,t} \quad \text{and} \quad \frac{P_{i,h,t}^*}{P_t^*} = \frac{P_{i,h,t}^*}{P_{h,t}^*} \frac{P_{h,t}^*}{P_t^*} \equiv p_{i,h,t}^* p_{h,t}^*.$$

Note that $p_{i,h,t}$ and $p_{i,h,t}^*$ are prices charged by home country firm i relative to the average price level chosen by the home country firms in the home and foreign markets, respectively; $p_{h,t}$ and $p_{h,t}^*$, on the other hand, are the average price levels relative to the CPI in the home and foreign markets, respectively and as such are taken as given by individual firms. From the perspective of firms in the foreign country, the relative prices $p_{i,f,t}$, $p_{i,f,t}^*$, $p_{f,t}$, and $p_{f,t}^*$ are interpreted in the same way.

We now turn to the problem of the firm, which to conserve space, we describe from the vantage point of the home country. A home country firm maximizes the present value of real dividends, subject to a flow-of-funds constraint:

$$\begin{aligned} d_{i,t} &= p_{i,h,t} p_{h,t} c_{i,h,t} + q_t p_{i,h,t}^* p_{h,t}^* c_{i,h,t}^* - w_t h_{i,t} + \varphi \min\{0, d_{i,t}\} \\ &\quad - \frac{\gamma_p}{2} \left(\frac{p_{i,h,t}}{p_{i,h,t-1}} \pi_{h,t} - 1 \right)^2 c_t - \frac{\gamma_p}{2} q_t \left(\frac{p_{i,h,t}^*}{p_{i,h,t-1}^*} \pi_{h,t}^* - 1 \right)^2 c_t^*, \end{aligned} \quad (10)$$

where $w_t = W_t/P_t$ is the real wage, $q_t = Q_t P_t^*/P_t$ is the real exchange rate, and $\pi_{h,t} = P_{h,t}/P_{h,t-1}$ and $\pi_{h,t}^* = P_{h,t}^*/P_{h,t-1}^*$ are the market-specific (gross) inflation rates faced by firms in the home country. The firm’s problem is also subject to the law of motion for the habit stock (6), the demand constraint (7), and a production constraint:

$$\left(\frac{A_t}{a_{i,t}} h_{i,t} \right)^\alpha - \phi \geq c_{i,h,t} + c_{i,h,t}^*. \quad (11)$$

Formally, the firm is choosing the sequence $\{d_{i,t}, h_{i,t}, c_{i,h,t}, c_{i,h,t}^*, s_{i,h,t}, s_{i,h,t}^*, p_{i,h,t}, p_{i,h,t}^*\}_{t=0}^{\infty}$ to optimize the following Lagrangian:

$$\begin{aligned}
\mathcal{L} = \mathbb{E}_0 \sum_{t=0}^{\infty} m_{0,t} & \left\{ d_{i,t} + \kappa_{i,t} \left[\left(\frac{A_t}{a_{i,t}} h_{i,t} \right)^{\alpha} - \phi - (c_{i,h,t} + c_{i,h,t}^*) \right] \right. \\
& + \xi_{i,t} \left[p_{i,h,t} p_{h,t} c_{i,h,t} + q_t p_{i,h,t}^* p_{h,t}^* c_{i,h,t}^* - w_t h_{i,t} - d_{i,t} + \varphi \min\{0, d_{i,t}\} \right. \\
& - \frac{\gamma_p}{2} \left(\frac{p_{i,h,t}}{p_{i,h,t-1}} \pi_{h,t} - 1 \right)^2 c_t - \frac{\gamma_p}{2} q_t \left(\frac{p_{i,h,t}^*}{p_{i,h,t-1}^*} \pi_{h,t}^* - 1 \right)^2 c_t^* \left. \right] \\
& + \nu_{i,h,t} \left[(p_{i,h,t})^{-\eta} \tilde{p}_{h,t}^{\eta} s_{i,h,t-1}^{\theta(1-\eta)} x_{h,t} - c_{i,h,t} \right] + \nu_{i,h,t}^* \left[(p_{i,h,t}^*)^{-\eta} \tilde{p}_{h,t}^{*\eta} s_{i,h,t-1}^{*\theta(1-\eta)} x_{h,t}^* - c_{i,h,t}^* \right] \\
& \left. + \lambda_{i,h,t} \left[\rho s_{i,h,t-1} + (1-\rho) c_{i,h,t} - s_{i,h,t} \right] + \lambda_{i,h,t}^* \left[\rho s_{i,h,t-1}^* + (1-\rho) c_{i,h,t}^* - s_{i,h,t}^* \right] \right\}, \tag{12}
\end{aligned}$$

where $\tilde{p}_{h,t} = \tilde{P}_{h,t}/P_{h,t}$ and $\tilde{p}_{h,t}^* = \tilde{P}_{h,t}^*/P_{h,t}^*$; $\kappa_{i,t}$ and $\xi_{i,t}$ are the Lagrange multipliers associated with the production constraint (11) and the flow-of-funds constraint (10), respectively; $\nu_{i,h,t}$ and $\nu_{i,h,t}^*$ are the Lagrange multipliers associated with the domestic and foreign demand constraints (equation (7) and its foreign counterpart); and $\lambda_{i,h,t}$ and $\lambda_{i,h,t}^*$ are the multipliers associated with the domestic and foreign habit accumulation processes (equation (6) and its foreign counterpart).

We begin by describing the firm's optimal choice of labor hours and dividends (or equity issuance), two decisions that are made *after* the realization of the idiosyncratic cost shock a_{it} . In contrast to these two decisions, the optimality conditions for prices ($p_{i,h,t}, p_{i,h,t}^*$), production ($c_{i,h,t}, c_{i,h,t}^*$), and habit stocks ($s_{i,h,t}, s_{i,h,t}^*$) in the domestic and foreign markets are determined prior to the realization of the idiosyncratic cost shock. For maximum intuition, we focus on the case without sticky prices. We then discuss the implications of our model for inflation and the Phillips curve in an environment where firms face quadratic costs of changing prices.

The efficiency condition for labor hours in problem (12) is given by

$$a_{i,t} \xi_{i,t} w_t = \kappa_{i,t} \alpha A_t \left(\frac{A_t}{a_{i,t}} h_{i,t} \right)^{\alpha-1}, \tag{13}$$

where given the production function, labor hours satisfy the conditional labor demand:¹⁷

$$h_{i,t} = \frac{a_{i,t}}{A_t} (\phi + c_{i,h,t} + c_{i,h,t}^*)^{\frac{1}{\alpha}}. \tag{14}$$

Our timing assumptions imply that $c_{i,h,t}$ and $c_{i,h,t}^*$ are determined prior to the realization of the idiosyncratic cost shock $a_{i,t}$. Combining equations (13) and (14), applying the expectation operator $\mathbb{E}_t^a[x] \equiv \int x dF(a)$ to both sides of the resulting expression, and dividing through by $\mathbb{E}_t^a[\xi_{i,t}]$ yields

¹⁷This conditional labor demand ensures a symmetric equilibrium, in which all firms produce an identical level of output regardless of their productivity. Relatively inefficient firms, however, have to hire more labor to produce the same level of output as their more efficient counterparts, which exposes the inefficient firms to ex-post liquidity risk.

the following expression for the expected real marginal cost normalized by the expected shadow value of internal funds:

$$\frac{\mathbb{E}_t^a[\kappa_{i,t}]}{\mathbb{E}_t^a[\xi_{i,t}]} = \frac{\mathbb{E}_t^a[a_{i,t}\xi_{i,t}]}{\mathbb{E}_t^a[\xi_{i,t}]} \frac{w_t}{\alpha A_t} (\phi + c_{i,h,t} + c_{i,h,t}^*)^{\frac{1-\alpha}{\alpha}}. \quad (15)$$

To understand the economic content behind this expression, consider first the case with no financial frictions. Hence, the shadow value of internal funds $\xi_{i,t} = 1$, for all i and t , implying that $\mathbb{E}_t^a[\xi_{i,t}] = 1$ and $\mathbb{E}_t^a[a_{i,t}\xi_{i,t}] = \mathbb{E}_t^a[a_{i,t}]\mathbb{E}_t^a[\xi_{i,t}] = 1$. With constant returns-to-scale (i.e., $\alpha = 1$), the expected real marginal cost $\mathbb{E}_t^a[\kappa_{i,t}] = w_t/A_t$, that is, unit labor costs. With the decreasing returns-to-scale (i.e., $\alpha < 1$), the expected real marginal cost is also a function of the firm's output: $\mathbb{E}_t^a[\kappa_{i,t}] = (w_t/\alpha A_t)(\phi + c_{i,h,t} + c_{i,h,t}^*)^{\frac{1-\alpha}{\alpha}}$.

In the presence of financial frictions, however, the shadow value of internal funds is not always equal to 1 and becomes stochastic, according to the realization of the idiosyncratic cost shock $a_{i,t}$, which influences the liquidity position of the firm. The first-order condition for dividend payouts (or equity issuance) implies that

$$\xi_{i,t} = \begin{cases} 1 & \text{if } d_{i,t} \geq 0; \\ 1/(1 - \varphi) & \text{if } d_{i,t} < 0. \end{cases} \quad (16)$$

In other words, the shadow value of internal funds is equal to 1 when the firm's revenues are sufficiently high to cover labor and fixed costs, and thus the firm pays dividends. If, however, the firm incurs an operating loss, it must issue new equity to cover its losses, and the shadow value of internal funds jumps to $1/(1 - \varphi)$. Intuitively, given the equity dilution costs, a firm must issue $1/(1 - \varphi)$ units of equity to obtain one unit of cashflow. These conditions imply that $\mathbb{E}_t^a[\xi_{i,t}] > 1$. It is also the case that the realized shadow value of internal funds covaries positively with the idiosyncratic cost shock $a_{i,t}$, as profits and hence dividends are negative when costs are high. As we show below, this implies

$$\frac{\mathbb{E}_t^a[a_{i,t}\xi_{i,t}]}{\mathbb{E}_t^a[\xi_{i,t}]} > 1.$$

Financial frictions, therefore, raise the normalized real marginal cost given by equation (15).

3.4 Optimal Pricing in a Symmetric Equilibrium

With risk-neutral firms and i.i.d. idiosyncratic costs shocks, our timing assumptions imply that all firms in a given country are identical ex ante. As a result, we focus on an equilibrium that has a number of symmetric features. Specifically, all home country firms choose identical relative prices ($p_{i,h,t} = 1$ and $p_{i,h,t}^* = 1$), scales of production ($c_{i,h,t} = c_{h,t}$ and $c_{i,h,t}^* = c_{h,t}^*$), and habit stocks ($s_{i,h,t} = s_{h,t}$ and $s_{i,h,t}^* = s_{h,t}^*$). The symmetric equilibrium condition $p_{i,h,t} = p_{i,h,t}^* = 1$ implies that firms in the home country set the same relative prices in domestic and foreign markets

vis-à-vis other competitors from the same origin.¹⁸ Similarly, foreign firms make pricing decisions among themselves, both in the domestic and foreign markets, such that $p_{i,f,t} = p_{i,f,t}^* = 1$. The asymmetric nature of financial conditions induces differences in the firms' internal liquidity positions and causes home and foreign firms to adopt different pricing policies. As a result, $p_{h,t} = P_{h,t}/P_t \neq 1$, $p_{h,t}^* = P_{h,t}^*/P_t^* \neq 1$, $p_{f,t} = P_{f,t}/P_t \neq 1$, and $p_{f,t}^* = P_{f,t}^*/P_t^* \neq 1$, implying that $p_{h,t} \neq p_{f,t}$ and $p_{h,t}^* \neq p_{f,t}^*$, in general. As we show below, the relatively weaker financial position of home firms forces them to maintain higher prices and markups in the neighborhood of the nonstochastic steady state, such that $p_h > p_f$ and $p_h^* > p_f^*$.

Imposing the relevant symmetric equilibrium conditions, the firm's internal funds are given by revenues less production costs:

$$p_{h,t}c_{h,t} + q_t p_{h,t}^* c_{h,t}^* - w_t \frac{a_{i,t}}{A_t} (\phi + c_{h,t} + c_{h,t}^*)^{\frac{1}{\alpha}},$$

where we substituted the conditional labor demand (14) for h_t . The firm resorts to costly external finance—that is, issues new shares—if and only if

$$a_{i,t} > a_t^E \equiv \frac{A_t}{w_t} \left[\frac{p_{h,t}c_{h,t} + q_t p_{h,t}^* c_{h,t}^*}{(\phi + c_{h,t} + c_{h,t}^*)^{\frac{1}{\alpha}}} \right]. \quad (17)$$

Using the above definition of the equity issuance threshold a_t^E , we can rewrite the first-order conditions for dividends (16) as

$$\xi_{i,t} = \begin{cases} 1 & \text{if } a_{i,t} \leq a_t^E; \\ 1/(1 - \varphi) & \text{if } a_{i,t} > a_t^E, \end{cases}$$

which states that because of costly external financing, the shadow value of internal funds jumps from 1 to $1/(1 - \varphi) > 1$ when the realization of the idiosyncratic cost shock $a_{i,t}$ exceed the threshold value a_t^E . Let z_t^E denote the standardized value of a_t^E (i.e., $z_t^E = (\ln a_t^E + 0.5\sigma^2)/\sigma$). Taking expectations, the expected shadow value of internal funds is given by

$$\mathbb{E}_t^a[\xi_{i,t}] = \int_0^{a_t^E} dF(a) + \int_{a_t^E}^{\infty} \frac{1}{1 - \varphi} dF(a) = 1 + \frac{\varphi}{1 - \varphi} [1 - \Phi(z_t^E)] \geq 1,$$

where $\Phi(\cdot)$ denotes the standard normal CDF. Thus, the expected shadow value of internal funds is strictly greater than one as long as equity issuance is costly ($\varphi > 0$) and future costs are uncertain ($\sigma > 0$). As emphasized by GSSZ, this makes firms de facto risk averse when making their pricing decisions: A policy of setting a low markup and committing to fulfilling the resulting large number of orders exposes the firm to operating losses, which must be covered by issuing costly new equity. A defensive pricing strategy is to choose a higher markup, which would not be optimal in an

¹⁸Recall that $p_{i,h,t}$ and $p_{i,h,t}^*$ are relative prices measured against average prices charged by firms in the home country. These are different from the relative prices against local and foreign CPIs, which are averages of prices of both domestic and imported goods (see equation 9).

environment with frictionless financial markets.

In our context, $\mathbb{E}_t^a[\xi_{i,t}]$ directly captures the firm's ex-ante valuation of an additional unit of cashflow obtained from increasing marginal revenue. As discussed above, the firm's ex ante internal valuation of marginal cost depends on $\mathbb{E}_t^a[\xi_{i,t}a_{i,t}]$. From the assumption that $\mathbb{E}_t^a[a_{i,t}] = 1$ and properties of the log-normal distribution (see Kotz et al., 2000), it follows that

$$\mathbb{E}_t^a[\xi_{i,t}a_{i,t}] - \mathbb{E}_t^a[\xi_{i,t}] = \text{Cov}[\xi_{i,t}, a_{i,t}] = \frac{\varphi}{1 - \varphi} [\Phi(z_t^E) - \Phi(z_t^E - \sigma)] > 0.$$

Because the realized shadow value of internal funds covaries positively with the cost shock, the ex ante internal valuation of marginal cost exceeds the ex-ante valuation of marginal revenue, so that

$$\frac{\mathbb{E}_t^a[\xi_{i,t}a_{i,t}]}{\mathbb{E}_t^a[\xi_{i,t}]} = 1 + \text{Cov}[\xi_{i,t}, a_{i,t}] = \frac{1 - \varphi\Phi(z_t^E - \sigma)}{1 - \varphi\Phi(z_t^E)} > 1,$$

where the second equality again follows from properties of the log-normal distribution.

To streamline notation, we define the markup—denoted by $\tilde{\mu}_t$ —as the inverse of real marginal cost inclusive of financing costs:

$$\tilde{\mu}_t = \left[\frac{\mathbb{E}_t^a[a_{i,t}\xi_{i,t}]}{\mathbb{E}_t^a[\xi_{i,t}]} \frac{w_t}{\alpha A_t} (\phi + c_{h,t} + c_{h,t}^*)^{\frac{1-\alpha}{\alpha}} \right]^{-1}.$$

Imposing the symmetric equilibrium conditions, we can express (see Section A of the Appendix) the firm's optimal pricing strategies in the domestic and foreign markets as

$$p_{h,t} = \frac{\eta}{\eta - 1} \frac{1}{\tilde{\mu}_t} + (1 - \rho)\theta\eta\mathbb{E}_t \left[\sum_{s=t+1}^{\infty} \beta_{h,t,s} \frac{\mathbb{E}_s^a[\xi_{i,s}]}{\mathbb{E}_t^a[\xi_{i,t}]} \left(p_{h,s} - \frac{1}{\tilde{\mu}_s} \right) \right]; \quad (18)$$

$$q_t p_{h,t}^* = \frac{\eta}{\eta - 1} \frac{1}{\tilde{\mu}_t} + (1 - \rho)\theta\eta\mathbb{E}_t \left[\sum_{s=t+1}^{\infty} \beta_{h,t,s}^* \frac{\mathbb{E}_s^a[\xi_{i,s}]}{\mathbb{E}_t^a[\xi_{i,t}]} \left(q_s p_{h,s}^* - \frac{1}{\tilde{\mu}_s} \right) \right], \quad (19)$$

where the growth-adjusted, compounded discount factors, $\beta_{h,t,s}$ and $\beta_{h,t,s}^*$, are given by

$$\beta_{h,t,s} = \begin{cases} m_{s-1,s} g_{h,s} & \text{if } s = t + 1; \\ m_{s-1,s} g_{h,s} \times \prod_{j=1}^{s-(t+1)} (\rho + \chi g_{h,t+j}) m_{t+j-1,t+j} & \text{if } s > t + 1; \end{cases}$$

$$\beta_{h,t,s}^* = \begin{cases} m_{s-1,s} g_{h,s}^* & \text{if } s = t + 1; \\ m_{s-1,s} g_{h,s}^* \times \prod_{j=1}^{s-(t+1)} (\rho + \chi g_{h,t+j}^*) m_{t+j-1,t+j} & \text{if } s > t + 1, \end{cases}$$

and where $g_{h,t} = \frac{s_{h,t}/s_{h,t-1}^{-\rho}}{1-\rho}$, $g_{h,t}^* = \frac{s_{h,t}^*/s_{h,t-1}^{*\rho}}{1-\rho}$, and $\chi = (1 - \rho)\theta(1 - \eta) > 0$.

In the absence of customer-market relationships (i.e., $\theta = 0$), the second term on the right-hand sides of equations (18) and (19) disappears, and we obtain the standard pricing equation for a static monopolist facing isoelastic demand: The price is equal to a constant markup, $\frac{\eta}{\eta-1}$, over current marginal cost, inclusive of financing costs. With customer markets (i.e., $\theta < 0$), prices are, on average, strictly lower than those that would have been set by the static monopolist because

firms have an incentive to lower prices in order to expand their market shares. Because of customer markets, the short-run demand elasticity in our model is less than its long-run counterpart, which implies a higher markup in the short run.¹⁹

Financial frictions create a tension between the firm’s desire to expand its market share and its desire to maintain adequate internal liquidity. The terms inside the square brackets represent the present values of future profits. When expanding market shares becomes more important, which happens through the increase in the growth-adjusted, compounded discount factors $\beta_{h,t,s}$ and $\beta_{h,t,s}^*$, the firm has a greater incentive to reduce prices because $\theta < 0$. However, when the firm faces a liquidity problem in the sense that the shadow value of internal funds today is strictly greater than its future values—that is, $\mathbb{E}_t^a[\xi_{i,t}] > \mathbb{E}_t^a[\xi_{i,s}]$, for $s > t$ —the firm discounts future profits more heavily. Again, the fact that $\theta < 0$ implies that the firm is more likely to raise prices in order to increase current cashflows, even though doing so cannibalizes its future market share.

3.5 Inflation Dynamics

Adding nominal rigidities to the model does not alter the nature of the optimal pricing problem in any fundamental way. The inherent tension between the maximization of market shares and the maximization of current profits that arises from the interaction of financial frictions and customer markets is also present in a version of the model with sticky prices. Therefore, instead of repeating the analysis, we simply close this section by showing how the well-known, log-linearized Phillips curve is modified owing to financial frictions and customer-market relationships.

Using equation (9), we can express the log-linearized dynamics of national CPIs as

$$\hat{\pi}_t = \Xi_h p_h (\hat{p}_{h,t-1} + \hat{\pi}_{h,t}) + \Xi_f p_f (\hat{p}_{f,t-1} + \hat{\pi}_{f,t}); \quad (20)$$

$$\hat{\pi}_t^* = \Xi_h^* p_h^* (\hat{p}_{h,t-1}^* + \hat{\pi}_{h,t}^*) + \Xi_f^* p_f^* (\hat{p}_{f,t-1}^* + \hat{\pi}_{f,t}^*), \quad (21)$$

where the variables with the “hat” denote log-linearized deviations from their respective steady-

¹⁹Note that in the steady state, $\beta_{h,t,s} = [\delta(\rho + \chi)]^{s-t}$. The pricing equation (18) then becomes

$$\begin{aligned} p_h &= \frac{\eta}{\eta-1} \frac{1}{\bar{\mu}} + \frac{\delta(\rho + \chi)(1-\rho)\theta\eta}{1-\delta(\rho + \chi)} \left(p_h - \frac{1}{\bar{\mu}} \right) \\ &= \left[\frac{\eta}{\eta-1} - \frac{\delta(\rho + \chi)(1-\rho)\theta\eta}{1-\delta(\rho + \chi)} \right] \frac{1}{\bar{\mu}} + \frac{\delta(\rho + \chi)(1-\rho)\theta\eta}{1-\delta(\rho + \chi)} p_h. \end{aligned}$$

Defining

$$\Theta = \frac{\delta(\rho + \chi)(1-\rho)\theta\eta}{1-\delta(\rho + \chi)},$$

and solving the above expression for p_h , yields

$$p_h = \left[1 + \frac{1}{(\eta-1)(1-\Theta)} \right] \frac{1}{\bar{\mu}},$$

which shows that the long-run relative price p_h is equal to the gross markup over real marginal cost, where the net markup is equal to $\frac{1}{(\eta-1)(1-\Theta)}$. For the net markup to be positive, we need to impose a condition $\frac{1}{(\eta-1)(1-\Theta)} > 0$; because $\eta > 1$, this is equivalent to $\Theta < 1$. Under our baseline calibration of the model (see Section 4 below), this condition is easily satisfied, and the long-run net markup is about 7 percent, compared with the short-run markup of 19 percent.

state values, which correspond to variables without the time subscript. Equations (20) and (21) illustrate how import prices affect the inflation dynamics of national CPIs. A full characterization of these dynamics requires a construction of Phillips curves for $\hat{\pi}_{h,t}$, $\hat{\pi}_{f,t}$, $\hat{\pi}_{h,t}^*$, and $\hat{\pi}_{f,t}^*$. For the sake of space, we focus on the first and the third.

The log-linearization of the first-order conditions for $p_{i,h,t}$ and $p_{i,h,t}^*$ implies:

$$\hat{\pi}_{h,t} = \frac{1}{\gamma_p} \frac{p_h c_h}{c} [\hat{p}_{h,t} - (\hat{\nu}_{h,t} - \hat{\xi}_t)] + \delta \mathbb{E}_t[\hat{\pi}_{h,t+1}]; \quad (22)$$

$$\hat{\pi}_{h,t}^* = \frac{1}{\gamma_p} q p_h^* \frac{c_h^*}{c^*} [\hat{q}_t + \hat{p}_{h,t}^* - (\hat{\nu}_{h,t}^* - \hat{\xi}_t)] + \delta \mathbb{E}_t[\hat{\pi}_{h,t+1}^*], \quad (23)$$

where $\hat{\nu}_{h,t}$, $\hat{\nu}_{h,t}^*$, and $\hat{\xi}_t$ are the log-deviations of $\mathbb{E}_t^a[\nu_{i,h,t}]$, $\mathbb{E}_t^a[\nu_{i,h,t}^*]$, and $\mathbb{E}_t^a[\xi_{i,t}]$ from their respective steady-state values. In the absence of customer markets, the terms in brackets are exactly equal to the log-deviation of the financially adjusted real marginal cost $\tilde{\mu}_t^{-1}$, and we recover the standard forward-looking Phillips curve for each market.

With customer markets, however, we obtain a considerably richer set of inflation dynamics. Substituting the log-linear dynamics of $\hat{\nu}_{h,t} - \hat{\xi}_t$ and $\hat{\nu}_{h,t}^* - \hat{\xi}_t$ into equations (22) and (23), respectively, yields the following Phillips curve for the domestic market:

$$\begin{aligned} \hat{\pi}_{h,t} = & \frac{1}{\gamma_p} \frac{p_h c_h}{c} \left[\hat{p}_{h,t} - \eta \left(\hat{p}_{h,t} + \frac{\hat{\mu}_t}{p_h \tilde{\mu}} \right) - \eta \chi \mathbb{E}_t \sum_{s=t+1}^{\infty} \tilde{\delta}^{s-t} \left(\hat{p}_{h,s} + \frac{\hat{\mu}_s}{p_h \tilde{\mu}} \right) \right] \\ & + \frac{\eta \chi}{\gamma_p} \frac{p_h c_h}{c} \left(1 - \frac{1}{p_h \tilde{\mu}} \right) \mathbb{E}_t \sum_{s=t+1}^{\infty} \tilde{\delta}^{s-t} [(\hat{\xi}_t - \hat{\xi}_s) - \hat{\beta}_{h,t,s}] + \delta \mathbb{E}_t[\hat{\pi}_{h,t+1}]; \end{aligned}$$

and for the foreign market:

$$\begin{aligned} \hat{\pi}_{h,t}^* = & \frac{1}{\gamma_p} q p_h^* \frac{c_h^*}{c^*} \left[\hat{q}_t + \hat{p}_{h,t}^* - \eta \left((\hat{q}_t + \hat{p}_{h,t}^*) + \frac{\hat{\mu}_t}{q p_h^* \tilde{\mu}} \right) + \chi \mathbb{E}_t \sum_{s=t+1}^{\infty} \tilde{\delta}^{s-t} \left((\hat{q}_s + \hat{p}_{h,s}^*) + \frac{\hat{\mu}_s}{q p_h^* \tilde{\mu}} \right) \right] \\ & + \frac{\eta \chi}{\gamma_p} q p_h^* \frac{c_h^*}{c^*} \left(1 - \frac{1}{q p_h^* \tilde{\mu}} \right) \mathbb{E}_t \sum_{s=t+1}^{\infty} \tilde{\delta}^{s-t} [(\hat{\xi}_t - \hat{\xi}_s) - \hat{\beta}_{h,t,s}^*] + \delta \mathbb{E}_t[\hat{\pi}_{h,t+1}^*], \end{aligned}$$

where $\tilde{\delta} = \delta(\rho + \chi)$. Because $\chi > 0$, the firm's heightened concern about its current liquidity position, as manifested by the fact that $\hat{\xi}_t - \hat{\xi}_s > 0$, will result in higher inflation in both markets. In contrast, the increased importance of future market shares at home and abroad, as captured by $\hat{\beta}_{h,t,s} > 0$ and $\hat{\beta}_{h,t,s}^* > 0$, leads to lower inflation in both markets. The terms $(\hat{\xi}_t - \hat{\xi}_s) - \hat{\beta}_{h,t,s}$ and $(\hat{\xi}_t - \hat{\xi}_s) - \hat{\beta}_{h,t,s}^*$, therefore, capture the fundamental tension between the maximization of current profits and the maximization of long-run market shares, a tension that importantly shapes inflation dynamics in periods of financial turmoil.

3.6 The Household's Problem

We now turn to the optimization problem of the representative household in the home country. First, we formulate this problem in an environment of flexible exchange rates. We then impose restrictions that deliver the baseline model of a monetary union.

3.6.1 Flexible Exchange Rates

The representative household in the home country works h_t hours. It allocates its savings between shares of the home country firms and international bonds that are not state contingent. We denote the home country's holdings of international bonds issued in home and foreign currency units by $B_{h,t+1}$ and $B_{f,t+1}$, respectively, while $B_{h,t+1}^*$ and $B_{f,t+1}^*$ denote their foreign counterparts.²⁰ The respective (gross) nominal interest rates on these securities are denoted by R_t and R_t^* .

We assume that investors in both countries face identical portfolio rebalancing costs, denoted by τ . Focusing on the home country, these costs are given by

$$\frac{\tau}{2} P_t \left[\left(\frac{B_{h,t+1}}{P_t} \right)^2 + q_t \left(\frac{B_{f,t+1}}{P_t^*} \right)^2 \right]; \quad (\tau > 0).$$

Under these assumptions, the marginal cost of borrowing in home currency is given by $R_t/(1 + \tau B_{h,t+1}/P_t)$, which is strictly greater than R_t if $B_{h,t+1} < 0$. The marginal return on foreign lending in home currency is given by $R_t(Q_t/Q_{t+1})/(1 + \tau B_{h,t+1}^*/P_t^*)$, which is strictly less than $R_t(Q_t/Q_{t+1})$ if $B_{h,t+1}^* > 0$. Thus, $(1 + \tau B_{h,t+1}/P_t)^{-1}$ represents a welfare loss, not only to the borrowers, but also to the lenders. As pointed out by [Ghironi and Melitz \(2005\)](#), the role of such portfolio rebalancing costs is to pin down the steady-state levels of international bond holdings, as varying τ does not modify the model dynamics in any significant way.

The number of outstanding shares of home country firm i is denoted by $S_{i,t}$, while $P_{i,t-1}^S$ is the period- t per-share value of the shares outstanding as of period $t - 1$ and $P_{i,t}^S$ is the (ex-dividend) per-share value of shares in period t . Using the fact that $\int_{N_k} P_{i,k,t} c_{i,k,t} di = \tilde{P}_{k,t} x_{k,t}$, for $k = h, f$, we can express the household's budget constraint as

$$\begin{aligned} 0 = & W_t h_t + R_{t-1} B_{h,t} + Q_t R_{t-1}^* B_{f,t} + \int_{N_h} [\max\{D_{i,t}, 0\} + P_{i,t-1}^S] S_{i,t}^S di \\ & - \tilde{P}_t x_t - B_{h,t+1} - Q_t B_{f,t+1} - \frac{\tau}{2} P_t \left[\left(\frac{B_{h,t+1}}{P_t} \right)^2 + q_t \left(\frac{B_{f,t+1}}{P_t^*} \right)^2 \right] - \int_{N_h} P_{i,t}^S S_{i,t+1}^S di \end{aligned} \quad (24)$$

The consumption expenditure problem is expressed as purchasing the habit-adjusted consumption bundle x_t using the price index \tilde{P}_t , which is possible because \tilde{P}_t is a welfare-based price index.

The representative household maximizes the life-time utility given by equation (5) subject to

²⁰Our notation implies that $B_{h,t+1} + B_{h,t+1}^* = 0$, where $B_{h,t+1}$ and $B_{h,t+1}^*$ are denominated in home currency—as denoted by the subscript h —and are held by the home and foreign country residents, respectively. If $B_{h,t+1} < 0$ ($B_{f,t+1} < 0$), the home country borrows money in home currency units (in foreign currency units) from the foreign country, whose claim is $B_{h,t+1}^* > 0$ ($B_{f,t+1}^* > 0$).

the budget constraint (24). Letting Λ_t denote the Lagrange multiplier associated with the budget constraint, the first-order condition for x_t is then given by $\Lambda_t = U_{x,t}/\tilde{P}_t = U_{x,t}/(\tilde{P}_t/P_t)P_t = (U_{x,t}/\tilde{p}_t)/P_t$. We can then express the first-order condition for hours worked as $U_{x,t}w_t/\tilde{p}_t = -U_{h,t}$.

The two equity valuation terms that appear in the budget constraint are related to each other through an accounting identity $P_{i,t}^S = P_{i,t-1}^S + E_{i,t}^S$, where $E_{i,t}^S$ is the per-share value of new equity issued by a firm i in period t . Because of equity dilution costs, $E_{i,t}^S = -(1 - \varphi) \min\{D_{i,t}, 0\}$. Substituting $P_{i,t-1}^S = P_{i,t}^S - E_{i,t}^S = P_{i,t}^S + (1 - \varphi) \min\{D_{i,t}, 0\}$ into the budget constraint (24), we obtain the optimality conditions governing the household's holdings of international bonds and shares of firms:

$$1 = \delta \mathbb{E}_t \left[\frac{U_{x,t+1}/\tilde{p}_{t+1}}{U_{x,t}/\tilde{p}_t} \left(\frac{R_t}{\pi_{t+1}} \frac{1}{1 + \tau b_{h,t+1}} \right) \right]; \quad (25)$$

$$1 = \delta \mathbb{E}_t \left[\frac{U_{x,t+1}/\tilde{p}_{t+1}}{U_{x,t}/\tilde{p}_t} \left(\frac{q_{t+1}}{q_t} \frac{R_t^*}{\pi_{t+1}^*} \frac{1}{1 + \tau b_{f,t+1}} \right) \right]; \quad (26)$$

$$1 = \delta \mathbb{E}_t \left[\frac{U_{x,t+1}/\tilde{p}_{t+1}}{U_{x,t}/\tilde{p}_{t+1}} \frac{1}{\pi_{t+1}} \left(\frac{\mathbb{E}_{t+1}^a[\tilde{D}_{i,t+1}] + P_{t+1}^S}{P_t^S} \right) \right], \quad (27)$$

where $\tilde{D}_{i,t} = \max\{D_{i,t}, 0\} + (1 - \varphi) \min\{D_{i,t}, 0\}$, $b_{h,t+1} = B_{h,t+1}/P_t$, and $b_{f,t+1} = B_{f,t+1}/P_t^*$.²¹ In deriving the first-order condition (27), we exploited the fact that the ex-ante value of the firm—the value prior to the realization of the idiosyncratic cost shock—is the same for all firms; that is, $\mathbb{E}_{t+1}^a[P_{i,t+1}^S] = P_{t+1}^S$ in the symmetric equilibrium.

The bond market clearing conditions are given by

$$0 = b_{h,t+1} + b_{h,t+1}^* \quad \text{and} \quad 0 = b_{f,t+1} + b_{f,t+1}^*, \quad (28)$$

where foreign holdings of international bonds denominated in home and foreign currencies— $b_{h,t+1}^*$ and $b_{f,t+1}^*$, respectively—satisfy the foreign counterparts of equations (25) and (26):

$$1 = \delta \mathbb{E}_t \left[\frac{U_{x,t+1}^*/\tilde{p}_{t+1}^*}{U_{x,t+1}^*/\tilde{p}_{t+1}^*} \frac{q_t}{q_{t+1}} \frac{R_t}{\pi_{t+1}} \frac{1}{1 + \tau b_{h,t+1}^*} \right];$$

$$1 = \delta \mathbb{E}_t \left[\frac{U_{x,t+1}^*/\tilde{p}_{t+1}^*}{U_{x,t+1}^*/\tilde{p}_{t+1}^*} \frac{R_t^*}{\pi_{t+1}^*} \frac{1}{1 + \tau b_{f,t+1}^*} \right].$$

Assuming that the portfolio rebalancing costs are transferred back to the household in a lump-sum fashion, imposing the stock market equilibrium condition $S_{i,t} = S_{i,t+1} = 1$, $i \in N_h$, and dividing the budget constraint through by P_t , equation (24) then implies the following law of

²¹Equity dilution costs do not affect the resource constraint because the existing shareholders' loss is exactly offset by the corresponding gain of new shareholders; both types of shareholders are, of course, the representative household and thus are the same.

motion for the bond holdings in the home country:

$$b_{h,t+1} + q_t b_{f,t+1} = \frac{R_{t-1}}{\pi_t} b_{h,t} + \frac{R_{t-1}^*}{\pi_t^*} q_t b_{f,t} + w_t h_t + \tilde{d}_t - \tilde{p}_t x_t, \quad (29)$$

where $\tilde{d}_t = \tilde{D}_t/P_t$; the corresponding law of motion for the bond holdings in the foreign country is given by

$$\frac{1}{q_t} b_{h,t+1}^* + b_{f,t+1}^* = \frac{R_{t-1}}{q_t \pi_t} b_{h,t}^* + \frac{R_{t-1}^*}{\pi_t^*} b_{f,t}^* + w_t^* h_t^* + \tilde{d}_t^* - \tilde{p}_t^* x_t^*, \quad (30)$$

where $\tilde{d}_t^* = \tilde{D}_t^*/P_t^*$. Multiplying equation (30) by q_t , subtracting the resulting expression from equation (29), and imposing the bond market clearing conditions given in equation (28) yields

$$b_{h,t+1} + q_t b_{f,t+1} = \frac{R_{t-1}}{\pi_t} b_{h,t} + \frac{R_{t-1}^*}{\pi_t^*} q_t b_{f,t} + \frac{1}{2} (w_t h_t - q_t w_t^* h_t^*) + \frac{1}{2} (\tilde{d}_t - q_t \tilde{d}_t^*) - \frac{1}{2} (\tilde{p}_t x_t - q_t \tilde{p}_t^* x_t^*). \quad (31)$$

This condition, together with bond market clearing conditions (28), should hold for the balance-of-payments between the two countries.

Closing the model requires us to specify a monetary policy rule. In the case of flexible exchange rates, we assume that monetary authorities in the home and foreign countries set prices of government bonds in their respective countries using interest-rate rules of the form:

$$R_t = R \left(\frac{y_t}{y} \right)^{\psi_y} \left(\frac{\pi_t}{\pi} \right)^{\psi_\pi} \quad \text{and} \quad R_t^* = R^* \left(\frac{y_t^*}{y^*} \right)^{\psi_y} \left(\frac{\pi_t^*}{\pi^*} \right)^{\psi_\pi},$$

where the reaction coefficients ψ_y and ψ_π are assumed to be the same across the two countries. We do not assume any policy inertia because such an inertial term is frequently a source of inefficiency in the conduct of monetary policy.²²

3.6.2 Monetary Union

In a monetary union, all products and financial assets are denominated in units of common currency. As a result, the nominal exchange rate Q_t is not defined. In addition, a single monetary authority sets the interest rate, denoted by R_t^U , and all investors, regardless of their country of origin and current location, earn the same nominal return on their bond holdings.²³ We assume that monetary

²²The output gap in the monetary policy rule does not correspond to the deviation of actual output from the efficient level of output—that is, the level of output that would prevail in the absence of nominal rigidities and inefficient sources of output fluctuations. However, when inefficient sources of output fluctuations are the primary driver of business cycles, which is the case in our calibration, our definition of the output gap works in the same way as the output gap implied by flexible prices.

²³However, the *real* returns on international bond holdings will differ in equilibrium, depending on the reference location of investors. This divergence in real returns reflects two factors. First, the two countries have different consumption baskets in the long run, owing to the presence of home bias in consumption. Second, at any point in time, the law of one price does not hold in the monetary union because two consumers residing in different countries have accumulated different stocks of habit for an identical product. Because firms price their products to markets—the so-called pricing to habits as in Ravn et al. (2007)—inflation rates are not equalized across countries, despite the adoption of a single currency and common monetary policy.

policy in the union is conducted in a manner that reflects the economic fundamentals of both countries:

$$R_t^U = R^U \left(\frac{y_t^U}{y^U} \right)^{\psi_y} \left(\frac{\pi_t^U}{\pi^U} \right)^{\psi_\pi},$$

where the union-wide variables are constructed as weighted averages of country-specific aggregates, with the weights given by the steady-state share of output:

$$y_t^U = y_t \left(\frac{y}{y + qy^*} \right) + q_t y_t^* \left(\frac{qy^*}{y + qy^*} \right) \quad \text{and} \quad \pi_t^U = \pi_t \left(\frac{y}{y + qy^*} \right) + \pi_t^* \left(\frac{qy^*}{y + qy^*} \right).$$

Because there is no longer any distinction between bonds issued in home or foreign currency, we replace the bond market clearing conditions (see equation 28) by

$$b_{t+1} + b_{t+1}^* = 0, \tag{32}$$

where b_{t+1} and b_{t+1}^* denote holdings of international bonds in the single currency units by home and foreign countries, respectively. Now there are two, instead of four, Euler equations characterizing the equilibrium in the international bond market:

$$1 = \delta \mathbb{E}_t \left[\frac{U_{x,t+1}/\tilde{p}_{t+1}}{U_{x,t+1}/\tilde{p}_{t+1}} \frac{R_t^U}{\pi_{t+1}} \frac{1}{1 + \tau b_{t+1}} \right]; \tag{33}$$

$$1 = \delta \mathbb{E}_t \left[\frac{U_{x,t+1}^*/\tilde{p}_{t+1}^*}{U_{x,t+1}^*/\tilde{p}_{t+1}^*} \frac{q_t}{q_{t+1}} \frac{R_t^U}{\pi_{t+1}^*} \frac{1}{1 + \tau b_{t+1}^*} \right]. \tag{34}$$

Note that $q_t/q_{t+1} = (Q_t/Q_{t+1})(\pi_{t+1}/\pi_{t+1}^*) = \pi_{t+1}/\pi_{t+1}^*$ in a monetary union. Finally, a monetary union implies that the combined law of motion for the international bond holdings given in equation (31) can be expressed as

$$b_{t+1} = \frac{R_{t-1}^U}{\pi_t} b_t + \frac{1}{2}(w_t h_t - q_t w_t^* h_t^*) + \frac{1}{2}(\tilde{d}_t - q_t \tilde{d}_t^*) - \frac{1}{2}(\tilde{p}_t x_t - q_t \tilde{p}_t^* x_t^*). \tag{35}$$

4 Calibration

There are three sets of parameters in the model: (1) parameters related to preferences and technology; (2) parameters governing the strength of nominal rigidities and the conduct of monetary policy; and (3) parameters determining the degree of financial market distortions, including portfolio rebalancing costs. In setting their values, our calibration strategy closely follows GSSZ, while expanding the set of parameters to the international environment.

Because the model is quarterly, we set the time discount factor equal to 0.996. The CRRA parameter in the household's utility function is set equal to 2. As we explain below, we specify the same degree of persistence (0.90) for all exogenous shock processes (i.e., aggregate demand shocks, aggregate technology shocks, and financial shocks). We then adjust the volatilities of shocks to

match the variance-decomposition shares of output fluctuations.

We set the deep habit parameter θ to -0.86 , a value similar to that used by [Ravn et al. \(2006\)](#). The key tension between the maximization of a long-run market share and the maximization of current profits does not exist when $\theta = 0$. In such an environment, the financial shock we consider has considerably smaller effect on economic outcomes. It is in this sense that our model owes a lot to customer-market considerations as captured by deep habits. Consequently, we follow [Ravn et al. \(2006\)](#) and choose a fairly persistent habit-formation process, so that only 15 percent of the habit stock depreciates in a given quarter ($\rho = 0.85$), a choice that highlights firms' incentives to compete for market share.

The elasticity of substitution η is a key parameter in the customer-markets model because the greater the firm's market power, the greater the incentive to invest in customer base. We set η equal to 2, a value consistent with [Broda and Weinstein \(2006\)](#), who provide a range of estimates of η for the U.S. economy; their estimates lie between 2.1 and 4.8, depending on the characteristics of products (commodities vs. differentiated goods) and sub-samples (before 1990 vs. after 1990). Our choice of $\eta = 2$ corresponds closely to the median value of the estimated elasticities for differentiated goods for the post-1990 period, a class of products that is most relevant for the deep habits framework; this choice is also broadly consistent with [Ravn et al. \(2010\)](#), who estimate η equal to 2.48 within a context of the deep habits model.

Regarding Ξ_h and Ξ_f (and Ξ_f^* and Ξ_h^*), the weights of home and foreign goods in the household's utility function, we choose their values so that the share of imported goods in the steady-state consumption basket is equal to 0.4 in both countries, a value in the middle of the range of the import-to-GDP ratios for the euro area countries since 2000.²⁴ As for the Armington elasticity, we set ε equal to 1.5, in order to stay close to the near-unit elasticity estimated by [Feenstra et al. \(2014\)](#).²⁵

The fixed operating costs ϕ and ϕ^* are another two key parameters in our model. In our baseline calibration, we assume $\phi = \phi^*$, which implies that differences in the degree of financial distortions are the sole source of heterogeneity between the two countries. We calibrate ϕ in conjunction with the returns-to-scale parameter α . Specifically, we set α first and then choose ϕ so that the dividend-payout ratio (relative to operating income) hits 2.5 percent, the mean of this ratio in the U.S. since 1945, which is close to the average dividends-and-buyback ratio of 3 percent for the European OECD countries during the 2002–2015 period. Following the international macroeconomics literature, we set $\alpha = 1$; in turn, this implies that $\phi = 0.1$. With $\alpha = 1$, $\phi = 0.1$, and $\eta = 2$, the average short-run gross markup in our model comes out at 1.19, while the long-run gross markup is equal to 1.07.

In calibrating the degree of financial distortions faced by domestic firms, we set the equity

²⁴Note that Ξ_f itself is not equal to the share of imported goods in the GDP of the home country; rather Ξ_f is chosen such that $\Xi_f^\varepsilon = p_f c_f / \sum_{k=h,f} p_k c_k = 0.4$.

²⁵As long as $\varepsilon > 1$, a value lower than 1.5 does not affect our main results. For example, setting ε close to 1 reduces the impact of a financial shock on aggregate output in a monetary union to two-thirds of that implied by our baseline calibration. This is because the lower elasticity of cross-border substitution implies a less intense price war between firms of the two countries. However, even in this extreme case, the qualitative features of the equilibrium remain the same.

dilution cost parameter φ equal to 0.2, a value that is in the middle of the range typically used in the corporate finance literature. The degree of financial frictions faced by foreign firms φ^* is then calibrated to be one-tenth of φ (i.e., $\varphi^* = 0.1\varphi$), implying a considerably more accommodative financial conditions for foreign country firms in the steady state. The volatility of the idiosyncratic cost shock σ is set to 0.2 at a quarterly frequency. With $\varphi = 0.2$ and $\phi = 0.1$, this level of idiosyncratic volatility implies that the expected shadow value of internal funds equals 1.16 for home country firms in the steady state.

For the parameters related to nominal rigidities, we set γ_p , the quadratic adjustment costs of nominal prices, equal to 10 in both countries. In presenting the model, we treated nominal wages as completely flexible. However, given the importance of (downward) nominal wage rigidities in periphery economies during the eurozone crisis (see [Schmitt-Grohé and Uribe, 2013, 2016](#)), we introduce (symmetric) nominal wage rigidities in the actual simulations along the lines of [Bordo et al. \(2000\)](#) and [Erceg et al. \(2000\)](#). Specifically, we assume market power for households that supply labor to production firms and a quadratic cost of adjusting nominal wages. In this case, assuming a separable, constant elasticity of labor supply $U_{h,t} = -h_t^{1/\zeta}$, the efficiency condition for labor hours becomes

$$\eta_w \frac{h_t^{1/\zeta} / U_{x,t}}{w_t / \tilde{p}_t} = \eta_w - 1 + \gamma_w (\pi_{w,t} - \pi_w) \pi_{w,t} - \delta \mathbb{E}_t \left[\frac{U_{x,t+1} / \tilde{p}_{t+1}}{U_{x,t} / \tilde{p}_t} \gamma_w (\pi_{w,t+1} - \pi_w) \pi_{w,t+1} \frac{\pi_{w,t+1} h_{t+1}}{\pi_{t+1} h_t} \right]$$

where $\pi_{w,t} = W_t / W_{t-1}$, γ_w is the coefficient of nominal wage adjustment costs, and ζ is the labor supply elasticity, which we set equal to 5. In symmetry with our assumptions regarding nominal price rigidities, we set $\eta_w = 2$ and $\gamma_w = 30$ in both countries.²⁶ Finally, we assume that monetary policy is conducted using an interest-rate rule proposed by [Taylor \(1999\)](#). (Table B-1 in Section B of the Appendix conveniently summarizes our baseline calibration.)

5 Model Simulations

In this section, we use the model to analyze quantitatively the macroeconomic implications of home and foreign countries forming a monetary union—that is, adopting a common currency and hence common monetary policy—in an environment of asymmetric financial shocks.

²⁶Our choice for the degrees of price and wage stickiness are comparable to the point estimates of $\gamma_p = 14.5$ and $\gamma_w = 41$ obtained by [Ravn et al. \(2010\)](#), who show that deep habits substantially enhance the persistence of inflation without the need to impose an implausibly large degree nominal price stickiness. The addition of nominal wage rigidities does not materially modify any of our main results. It does, however, lead to a notably greater volatility of the real exchange rate because the countercyclical markups in the country where firms face acute financial distress are driven more by an increase in product prices as opposed to an immediate decline in nominal wages, which would have occurred in an environment with flexible wages. In the latter case, the more stable final product prices result in a less volatile real exchange rate, which runs counter to intuition, in addition to being at odds with the data.

5.1 Currency Regimes and the Impact of Asymmetric Financial Shocks

To analyze the effects of financial instability under various currency regimes, we posit an external financial shock, which temporarily raises the cost of outside equity capital for firms in the two countries. Specifically, the cost of issuing new shares is assumed to be subject to a “cost-of-capital” shock of the form:

$$\begin{aligned}\varphi_t &= \varphi f_t; & \text{where } \ln f_t &= \rho_f \ln f_{t-1} + \epsilon_{f,t}, \text{ with } \epsilon_{f,t} \sim N(-0.5\sigma_f^2, \sigma_f^2); \\ \varphi_t^* &= \varphi^* f_t^*; & \text{where } \ln f_t^* &= \rho_f \ln f_{t-1}^* + \epsilon_{f,t}^*, \text{ with } \epsilon_{f,t}^* \sim N(-0.5\sigma_f^2, \sigma_f^2).\end{aligned}$$

We calibrate the size of the shock $\epsilon_{f,t}$ such that φ_t jumps to 1.5φ upon impact and then returns to its normal level of $\varphi = 0.2$, according to the autoregressive dynamics specified above.²⁷ Because our baseline calibration assumes that $\varphi^* = 0.1\varphi$, the above formulation results in asymmetric financial conditions between the two countries, with home country firms facing a significantly higher cost of external finance. To further underscore the effects of differences in financial conditions faced by domestic and foreign firms, we keep the cost of external equity capital in the foreign country at $\varphi_t^* = 0.1\varphi$, for all t .

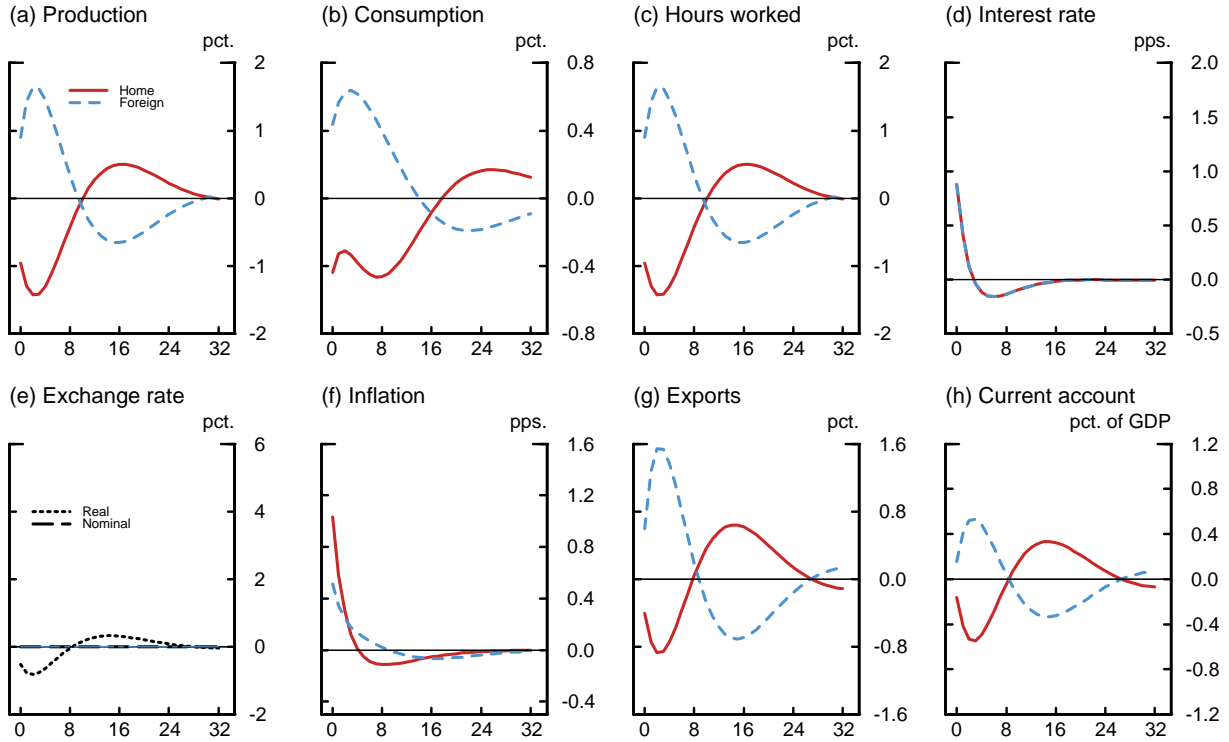
In this experiment, the financial shock increases the expected shadow value of internal funds for firms in the home country from 1.16 to 1.32 upon impact. Figure 4 displays the macroeconomic effects of such an asymmetric financial shock when the two countries share a common currency. As shown in panel (f), home country firms raise prices significantly in response to an adverse financial shock, a result consistent with that reported by GSSZ. Foreign inflation also increases somewhat, though not because of a price hike by foreign firms, but rather because of an increase in import prices.

At the same time, the burst of inflation in the home country is accompanied by an economic slump: Production declines notably in the immediate aftermath of the shock (panel (a)), as does consumption (panel (b)) and hours worked (panel (c)). Because the nominal exchange rate is unable to respond to the shock, the differential behavior of inflation in the two countries implies a notable appreciation of the real exchange rate (panel (e)). As a result, exports from the home country drop (panel (g)), and the home country’s current account deficit worsens in the near term (panel (h)). Strikingly, the downturn in the home country is accompanied by a robust boom in the foreign country: Production, consumption, hours worked, and exports all increase significantly, and the foreign country registers a sizable current account surplus.

As shown in Figure 5, the pattern of international macroeconomic adjustment in response to such a shock looks dramatically different when the two countries have their own currencies and are able to pursue independent monetary policies responding to their respective domestic economic developments. As in the monetary union case, home country firms again raise prices in response to an adverse financial shock (panel (f)), and foreign inflation rises slightly, reflecting the pass-through of higher import prices. With flexible exchange rates, however, the nominal exchange rate

²⁷As noted in Section 4, the persistence of all exogenous shock processes is set to 0.9; thus, we set $\rho_f = 0.9$.

FIGURE 4 – Financial Shock in the Monetary Union



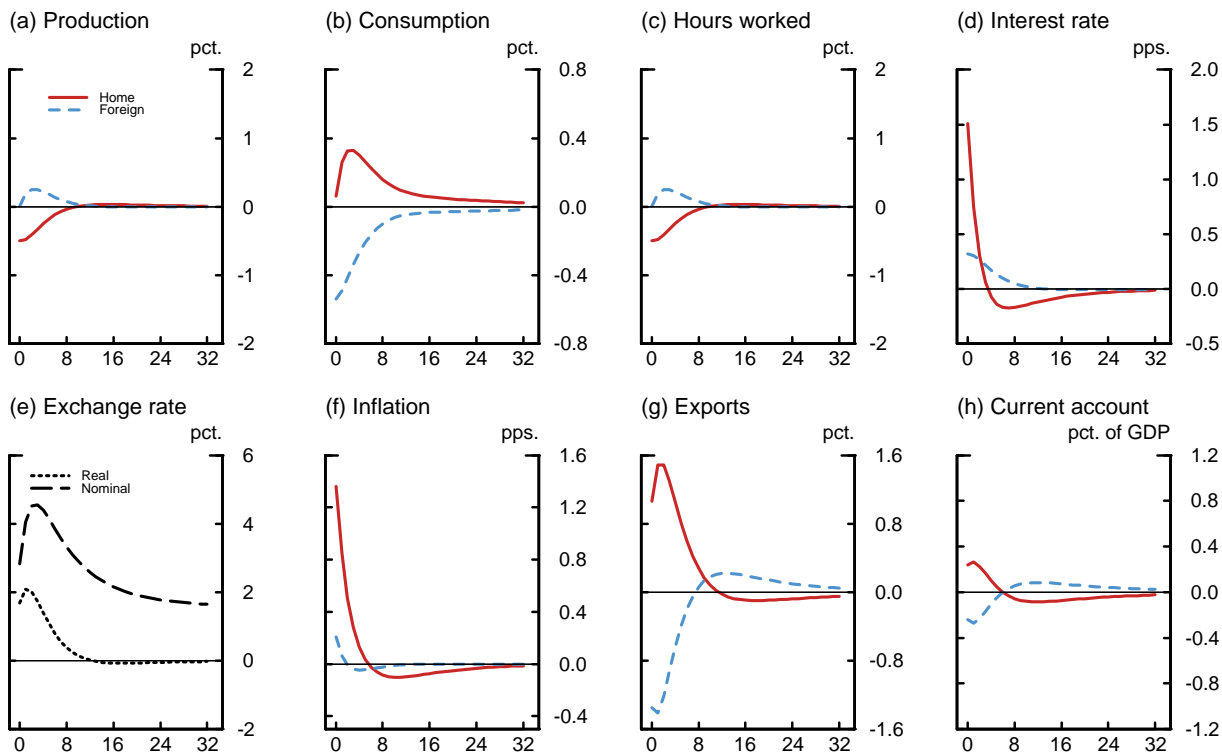
NOTE: The panels of the figure depict the model-implied responses of selected variables to an adverse financial shock in the home country in period 0 (see the text for details). Unless noted otherwise, the solid lines show responses of variables in the home country, while the dashed lines show those of the foreign country. Exchange rates (panel (e)) are expressed as home currency relative to foreign currency.

strongly depreciates (panel (e)). In fact, the depreciation is so large that the real exchange rate also depreciates, despite the inflation differential moving in the “wrong” direction. As in the data, therefore, the short-run dynamics of the real exchange rate are dominated by fluctuations in the nominal exchange rate, rather than by changes in the relative price levels.²⁸

As shown in panel (g), the depreciation of the real exchange rate significantly boosts the home country’s exports. However, because firms in the home country respond to the shock by raising prices and are facing downward-sloping demand curves, domestic production declines in response to the financial shock (panel (a)). Consequently, hours worked in the home country also decline (panel (c)). In the home country, therefore, the financial shock has real consequences in terms of the foregone output and employment, though the effects are relatively small, given the assumed severity and persistence of financial distress. The economic forces responsible for this stark difference in the international macroeconomic dynamics across the two currency regimes can be found in panels (d)–

²⁸The nominal exchange rate shown in panel (e) appears to return to its steady-state value in the long run. However, this is simply a coincidence because our New Keynesian framework does not have a prediction for the level of nominal exchange rate, just as it does not have one for the price level. In all simulations, we assume that the initial value of the nominal exchange rate is equal to 1, an arbitrary but innocuous assumption, as only changes in the nominal exchange rate are a well-defined concept in our model.

FIGURE 5 – Financial Shock with Flexible Exchange Rates



NOTE: The panels of the figure depict the model-implied responses of selected variables to an adverse financial shock in the home country in period 0 (see the text for details). Unless noted otherwise, the solid lines show responses of variables in the home country, while the dashed lines show those of the foreign country. Exchange rates (panel (e)) are expressed as home currency relative to foreign currency.

(f) of Figure 4. First, note that the behavior of inflation in the two countries when they are in a monetary union (panel (f) of Figure 4) is quite similar to that under a flexible exchange rate regime (panel (f) of Figure 5). This result reflects the fact that regardless of the currency arrangement, firms in the home country, when confronted with a tightening of financial conditions, have a strong incentive to raise prices compared with their foreign counterparts.

What differs between the two currency frameworks is, of course, the behavior of the real exchange rate. To understand this difference, note that with flexible exchange rates, the international bond-holding conditions (25) and (26) imply the following no-arbitrage condition:

$$\tau(b_{h,t+1} - b_{f,t+1}) = \mathbb{E}_t \left[m_{t,t+1} \left(\frac{R_t}{\pi_{t+1}} - \frac{q_{t+1}}{q_t} \frac{R_t^*}{\pi_{t+1}^*} \right) \right]. \quad (36)$$

In equilibrium with a relatively small portfolio rebalancing costs, the left side of equation (36) is close to zero up to a first-order approximation, which means that $R_t/\pi_{t+1} - (q_{t+1}/q_t)(R_t^*/\pi_{t+1}^*) \approx 0$ in expectation. Given the difference in the behavior of inflation and common monetary policy (see panels (d) and (f) of Figure 4), it is clear that the real interest rate in the home country is lower

than in the foreign country when the two countries are in a monetary union. In the absence of capital controls, the real exchange rate should therefore *appreciate* over time in expectation (i.e., $q_{t+1}/q_t < 1$), so as to prevent the flight of capital from the home country. This, however, requires the nominal exchange rate to *depreciate* immediately.

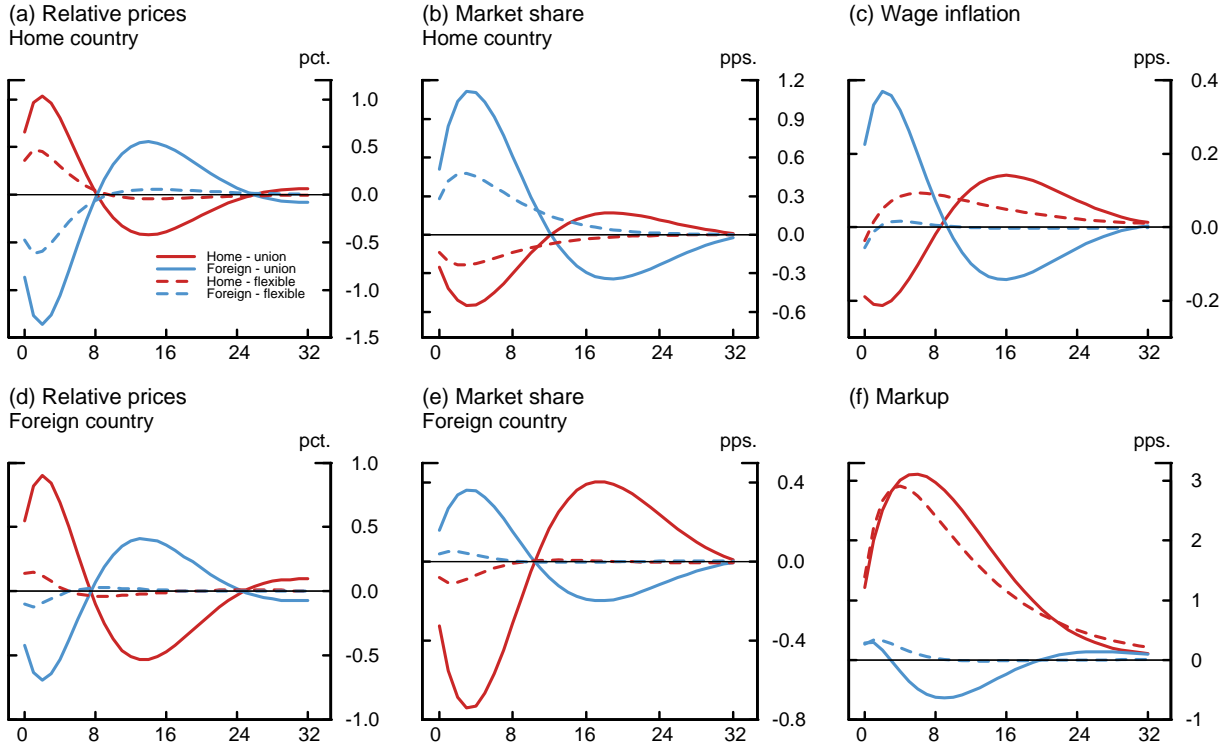
With the two countries sharing a common currency, such an adjustment is, of course, not possible. In a monetary union, the bond market efficiency conditions (33) and (34) impose no restrictions on dynamics of the real exchange rate. The real interest rate differential engendered by the difference in the behavior of inflation between the two countries does not have to be compensated by the expected changes in the nominal exchange rate. Adding the efficiency conditions (33) and (34) and imposing the bond market clearing condition yields

$$1 = \mathbb{E}_t \left[\frac{1}{2} \left(\frac{m_{t,t+1}}{\pi_{t+1}} + \frac{m_{t,t+1}^*}{\pi_{t+1}^*} \right) R_t^U \right],$$

which states that the union-wide policy rate R_t^U should be set according to the *average* of the fundamentals of the two economies, regardless of the coefficients of the monetary policy reaction function. As a result, differences in inflation rates translate directly into movements in the real exchange rate. Because firms in the home country optimally choose higher markups and relative prices in response to the tightening of financial conditions, the real exchange rate appreciates substantially and production and exports by home country firms drop sharply. In comparison, the decline in consumption is noticeably less severe because international borrowing—while subject to costly portfolio rebalancing—allows consumers in the home country to smooth the effects of the financial shock to a certain extent. The foreign economic boom is simply a mirror image of the home country’s economic plight and is reminiscent of the dichotomy in economic outcomes between the eurozone core and periphery during the recent financial crisis.

As shown in panels (a) and (d) of Figure 6, the financial shock in the home country induces a significant dispersion in relative prices in both countries, regardless of the currency regime. The increase in the cost of external finance causes home country firms to raise relative prices in both their domestic and export markets. Foreign country firms, in contrast, optimally follow the opposite strategy and lower relative prices in both markets in order to steal market share from their financially constrained home country counterparts (panels (b) and (e)). This “predatory” price war is noticeably more intense when the two countries share a common currency, as home country firms are unable to rely on the depreciation of their currency to improve their internal liquidity positions. And lastly, financial distress leads to a strongly countercyclical markup in the home country, irrespective of the currency regime (panel (f)). The model-implied dynamics of markups in the home country in response to a financial shock are thus consistent with the behavior of the price markups in the eurozone periphery during the recent financial crisis and its aftermath shown in Figure 3.

FIGURE 6 – Financial Shock and International Price War



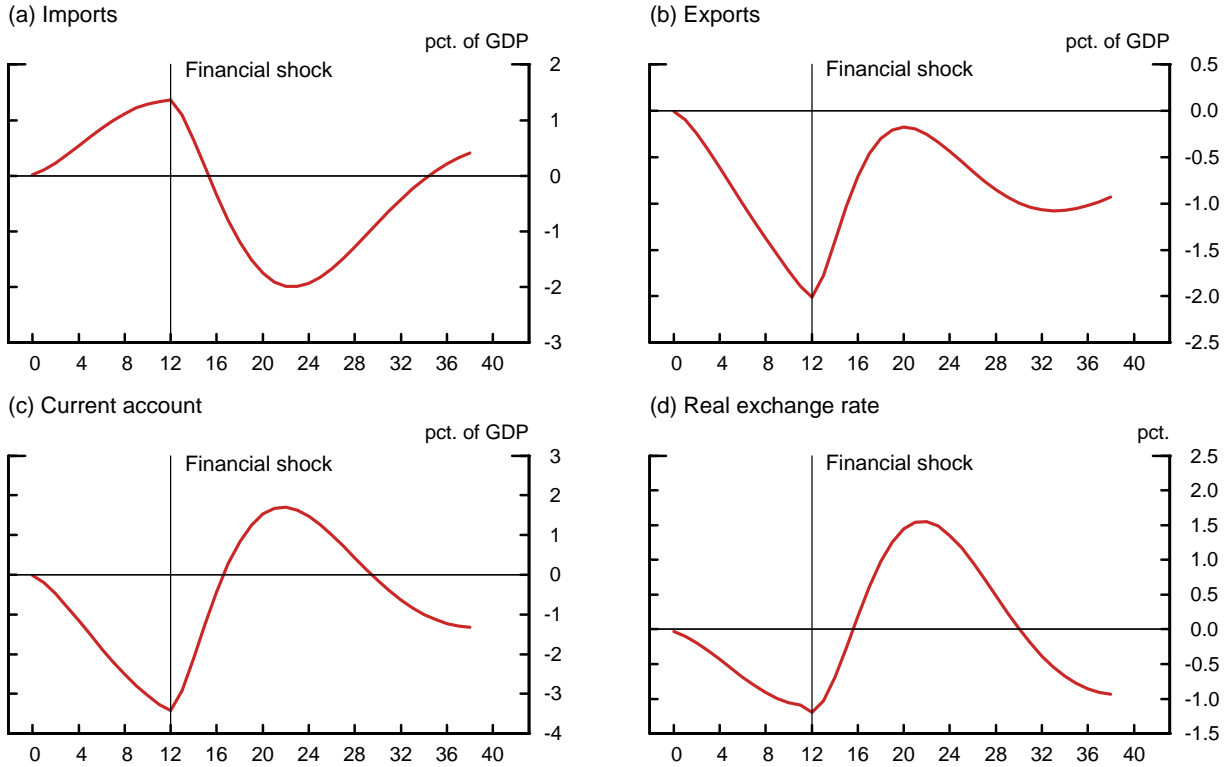
NOTE: The panels of the figure depict the model-implied responses of selected variables to an adverse financial shock in the home country in period 0 (see the text for details). The solid lines show responses when the two countries are in a monetary union, while the dashed lines show responses under flexible exchange rates.

5.2 The Boom-Bust Cycle

An aspect of the macroeconomic dynamics shown in Figure 4 that appears at odds with the crisis in the euro area periphery is the fact that following the financial shock, imports to the home country (that is, exports from the foreign country) increase notably (panel (g)), causing a deterioration in the current account deficit of the home country (panel (h)). After about eight quarters, this pattern is reversed, and the home country begins to register an improvement in its external position. The current account deficits in the periphery countries, however, started to improve immediately with the onset of the crisis in 2009 (panel (a) of Figure 1), owing primarily to a sharp decline in imports.

This discrepancy in the timing of external adjustment patterns should not be taken as evidence that the model-implied crisis dynamics are inconsistent with the data. The impulse responses are expressed as deviations from the steady state—that is, our simulations assume that the two economies are at their respective steady states prior to the home country being hit by a shock, a situation that is unlikely to have characterized the euro area on the eve of the crisis. In fact, with our model, it is straightforward to generate external adjustment patterns in the home country that closely resemble those experienced by the eurozone periphery in the period surrounding the sovereign debt crisis.

FIGURE 7 – Boom-Bust Cycle in the Home Country



NOTE: The solid lines depict the model-implied responses of selected variables in the home country, when the country experiences a sequence of positive demand shocks in periods $0, \dots, 11$ and in period 12 is hit by a financial shock (see the text for details). The real exchange rate is expressed as home currency relative to foreign currency.

As noted at the outset, periphery countries borrowed heavily in the years preceding the crisis, primarily to finance domestic consumption and housing investment. Consequently, real exchange rates in the eurozone periphery appreciated significantly, eroding these countries' competitiveness. These developments also produced large trade deficits among periphery countries, which in the years leading to the crisis were easily financed by foreign capital inflows, facilitated by the convergence in domestic interest rates across the euro area. To capture the buoyant economic sentiment that prevailed in the eurozone periphery prior to the crisis, we consider an experiment, whereby the home country first experiences a sequence of gradually increasing positive demand shocks ω_t —the pre-crisis economic boom—which is then followed by an asymmetric financial shock. In implementing this scenario, we assume a sequence of demand shocks in periods $0, 1, \dots, 11$, such that ω_t gradually increases to 5 percent of its steady-state value; in period 12, we hit the home country with a large and persistent financial shock, which increases the equity dilution costs φ_t from 0.2 to 0.35 upon impact.

As shown in Figure 7, this sequence of events generates external adjustment patterns in the home country that correspond closely to those experienced in the eurozone periphery in the period surrounding the crisis. In the years immediately preceding the financial shock, imports-to-GDP

increase notably (panel (a)), while exports-to-GDP fall (panel (b)), trade dynamics that are consistent with the erosion in the home country’s competitiveness as evidenced by the appreciation of the real exchange rate during this period (panel (d)). When the home country is hit by the financial shock, these patterns are abruptly reversed: With imports falling and exports rising, the current account deficit—which reached more than 3 percent of GDP at the eve of the crisis—begins to shrink immediately (panel (c)). Thus with an economically plausible sequence of shocks, the model is able to replicate the kind of current account reversal dynamics experienced by the eurozone periphery during the crisis.

5.3 “Kill My Neighbor’s Cow Too”

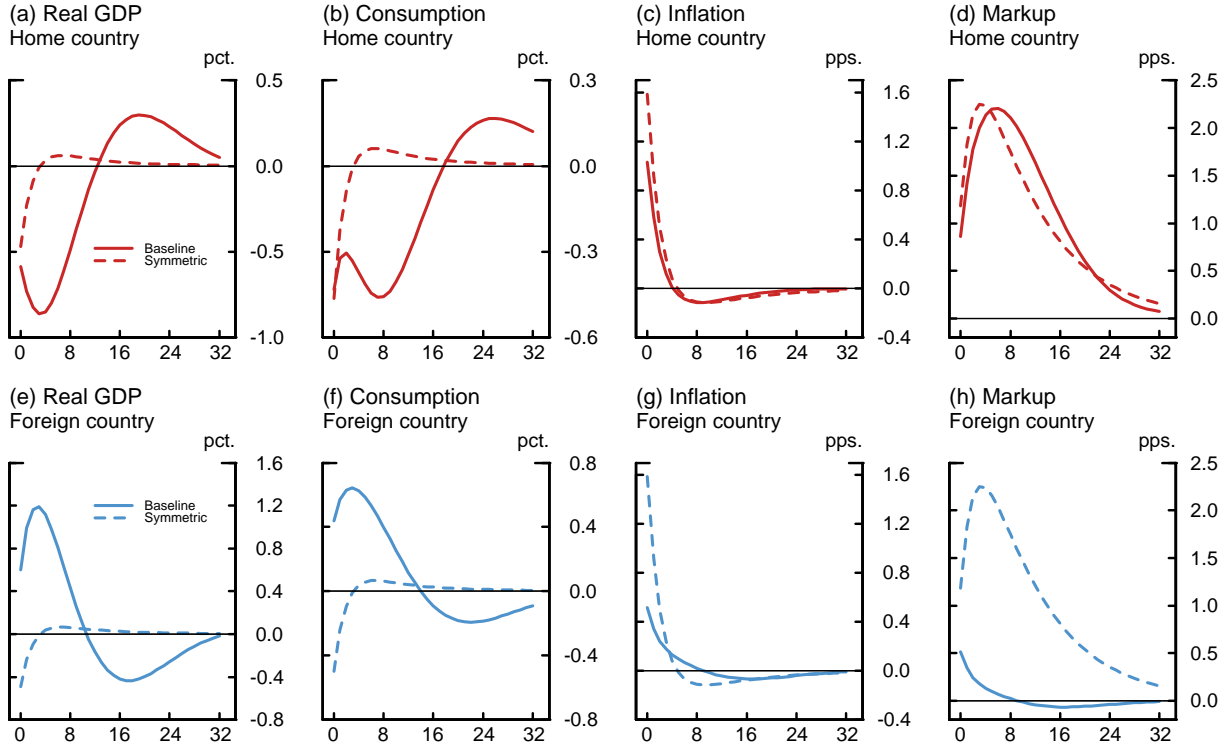
An old Slovenian joke tells of two neighboring peasants who each own a cow. One day, out of the blue, a lightning strikes and kills one of the cows. The poor peasant whose cow—his most prized possession—has been killed cries to God in anguish, begging for justice. When God replies and asks him what he wants Him to do, the peasant replies, “kill my neighbor’s cow too.”

In our model, the poor peasant’s situation resembles that of cash-strapped firms in the periphery, who in the midst of a financial crisis are fending off competitors from the core that are trying to increase their market shares by engaging in predatory pricing behavior. Asking to “kill the neighbor’s cow too” is akin to asking how would the periphery fare in a situation where the core has equally distorted financial markets and its firms are subjected to the same degree of financial distress, compared with the asymmetric set-up, whereby only the periphery’s financial markets are distorted and only the periphery is hit by a financial shock.

To shed light on this question, we consider an experiment in which firms in both countries face the same degree of financial frictions in the steady state ($\varphi = \varphi^* = 0.2$) and both economies are perturbed by a financial shock of the type described above ($\epsilon_t = \epsilon_t^* > 0$). The dashed lines in Figure 8 show the impulse responses of selected variables under this alternative “symmetric” calibration, while the solid lines show the corresponding responses under our baseline calibration and when only the home country is hit by a financial shock (see Figure 4).

The comparison of these two experiments clearly indicates that the home country would prefer the alternative economic environment, as evidenced by a much smaller impact on domestic output and consumption (panels (a) and (b)). As shown in panel (h), foreign firms—in response to the deterioration in their own financial conditions—raise markups significantly to maintain current cashflows. In other words, the symmetric financial distress does not allow foreign firms to engage in predatory pricing behavior. As a result, foreign inflation dynamics mirror those in the home country (panels (c) and (g)), and there is no movement in the real exchange rate. Hence, the foreign country undergoes the same contraction in economic activity as the home country (panels (a) and (e)), a result that stands in stark contrast to the baseline monetary union case, in which the foreign country experiences an export-driven boom, while the home country falls into a recession.

FIGURE 8 – Financial Heterogeneity and the Monetary Union



NOTE: The solid lines depict the model-implied responses of selected variables to an adverse financial shock in the home country in period 0 under the baseline calibration of the model. The dashed lines depict the corresponding responses under the alternative calibration of homogeneous financial capacity and when both countries are hit by an adverse financial shock in period 0; see the text for details.

6 Welfare Analysis and Policy Implications

Simulations in Section 5 show that when financial markets of countries in a monetary union are subject to a differing degree of financial distortions, the financially weaker members of the union undergo a much more severe recession when hit by an external shock, compared with a flexible exchange rate regime. In this section, we examine formally the welfare implications of forming a monetary union among countries with different financial capacities. To highlight the welfare effects of such a political choice, we adopt a calibration strategy, which assumes that the home and foreign countries are subject to only two types of aggregate shocks: technology shocks ($\epsilon_{A,t}$ and $\epsilon_{A,t}^*$) and financial shocks ($\epsilon_{f,t}$ and $\epsilon_{f,t}^*$). We set the standard deviation of aggregate technology shocks to 1 percent and then calibrate the standard deviation of financial shocks so that they account for 10 times as much of the variance of real GDP of the home country as technology shocks (see [Jermann and Quadrini, 2012](#)).²⁹

²⁹Consistent with our calibration strategy, we set $\rho_A = \rho_f = 0.9$. With financial shocks playing such a ρ_f outsized role in economic fluctuations, this calibration clearly does not provide the most realistic representation of the two economies. However, our main conclusions are qualitatively the same under alternative calibrations, whereby the business cycles are driven primarily by aggregate technology shocks.

TABLE 4 – Welfare Analysis

Welfare Comparison	Monetary Union	Flexible FX	CE (pct.)
Home country	−259.23	−254.16	2.53
Foreign country	−254.05	−254.26	−0.11
<i>Memo: Both countries</i>	−513.28	−508.42	.
Moments Comparison	$\mu(c^U)/\mu(c^F)$	$\sigma(c^U)/\sigma(c^F)$	$\sigma(h^U)/\sigma(h^F)$
Home country	0.99	1.55	2.92
Foreign country	1.01	1.51	4.31

NOTE: In the top panel, CE denotes the certainty-equivalent change in the average consumption per period (holding hours worked constant) that is required to make the representative household in the specified country no worse off when the two countries choose to abandon flexible exchange rates and independent monetary policies and form a monetary union. In the bottom panel, $\mu(c)$ = average consumption level; $\sigma(c)$ = volatility of consumption; and $\sigma(h)$ = volatility of hours worked. Currency arrangement: U = monetary union; and F = flexible exchange rates.

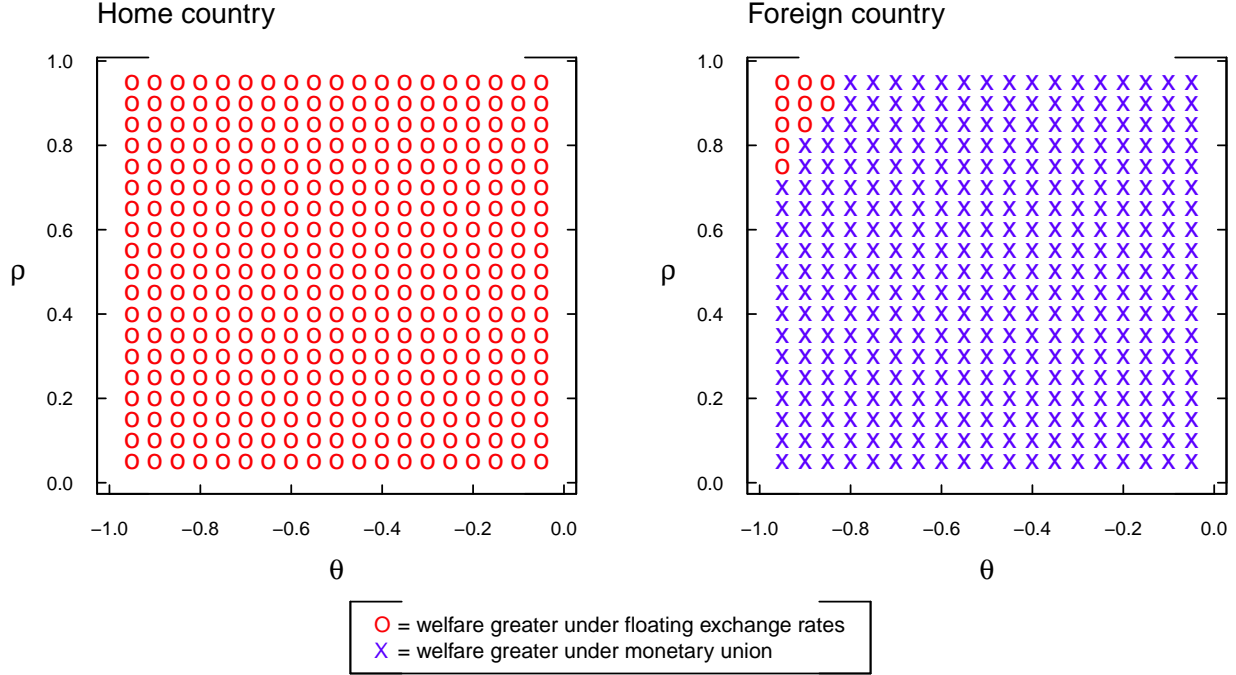
6.1 Welfare Consequences of Joining a Monetary Union

To compare welfare across the different currency regimes in such an environment, we approximate the value functions of the representative households in the two countries up to a second order and report their analytic first moments under our baseline calibration in the top panel of Table 4. In addition, we calculate the certainty-equivalent changes in consumption (CE), which are required to make the welfare levels of the households in two countries in the monetary union equal to those under the flexible exchange rate regime. As evidenced by these entries, joining a monetary union results in a significant welfare loss for the home country: The representative household in the home country should be given an increase of 2.5 percent of their steady-state consumption level per quarter in order to be as well off in the union as they were with flexible exchange rates. In contrast, the representative household in the foreign country is notably better off in the monetary union, given that typical estimates of the welfare cost of business cycles are on the order of 0.2 percent, according to the CE metric.

The bottom panel compares the selected moments of consumption and hours worked across the two currency frameworks. Abandoning its own currency and independent monetary policy to join the union results in a lower average level of consumption for the representative household in the home country and a correspondingly higher average consumption for the representative household in the foreign country. This result is due to the fact that in the monetary union home country firms lose market share to their foreign competitors in the long run. Interestingly, the volatilities of consumption and hours worked in both countries are appreciably higher when the two countries share a common currency.

The result that the welfare of the foreign country is higher in the monetary union than with flexible exchange rates runs counter to the conventional view in the international macroeconomics literature. This view, however, does not take into account the role that heterogeneity in financial capacities of countries comprising the union plays in incentivizing firms to compete for market share

FIGURE 9 – Welfare Gains and Losses from Dissolving the Monetary Union



NOTE: The two panels show the change in welfare of the representative household—over the relevant (θ, ρ) -space—in the home and foreign countries, in the case that the two countries dissolve the monetary union and adopt flexible exchange rates. The symbol “o” indicates that the welfare of the representative household is greater under a flexible exchange rate regime, while the symbol “x” indicates higher welfare when the two countries are in a monetary union.

by engaging in predatory pricing behavior. When a country with distorted and inefficient financial markets forms a monetary union with a country with relatively frictionless financial system, the former is highly vulnerable to the beggar-thy-neighbor pricing policies of firms in the latter country, especially in periods of financial distress. This is the main reason why independent monetary policy is such a valuable macroeconomic stabilization tool for the financially weak country and why the welfare of the home country is lower in the monetary union than with flexible exchange rates.³⁰

Figure 9 explores the robustness of this result across the different combinations of parameters θ and ρ , which govern the strength and persistence of the customer-market relationships. The symbol “o” indicates that the welfare of the representative household is greater under a flexible exchange rate regime, while the symbol “x” indicates higher welfare when the two countries are in a monetary union. According to the left panel, the welfare of the home country improves with the exit from the monetary union for all configurations of the parameters θ and ρ . As shown in the right panel, by contrast, the welfare of the foreign country is greater in the monetary union across

³⁰The welfare calculations reported in Table 4 are not predicated on optimal monetary policy. It is unlikely, however, that the welfare ordering would be reversed under optimal monetary policy because the Ramsey planner maximizing the joint welfare with two instruments—two short-term interest rates—can never do worse than the Ramsey planner with only one instrument, namely a union-wide short-term interest rate.

most of the (θ, ρ) -space, the exception being a small region of the parameter space characterized by a very strong and persistent deep-habit mechanism ($\theta < -0.9$ and $\rho > 0.9$).³¹ Thus, the welfare implications of a monetary union under our baseline calibration shown in Table 4 are not a knife-edged result, as they are robust for most of the combinations of the parameters θ and ρ .

6.2 Fiscal Devaluations

Given the union’s problem with a one-size-fits-all monetary policy, we now examine the welfare implications of a frequently advocated policy option in the context of the European sovereign debt crisis: a revenue-neutral fiscal devaluation by the periphery countries.³² [Adao et al. \(2009\)](#) and [Farhi et al. \(2014\)](#) have shown that various combinations of fiscal measures can replicate the effects of a nominal exchange rate depreciation in a fixed exchange rate system. Fiscal measures can, for example, include a combination of import tariffs and export subsidies or a shift from labor to consumption taxation.³³ A particular form of fiscal devaluation that received a lot of attention in policy circles during the crisis involved the following (revenue neutral) combination of fiscal measures in the periphery: a reduction in employers’ social security contributions, coupled with an increase in the VAT rate (see [Puglisi, 2014](#)).

To provide a qualitative insight into this question, we consider a scenario, whereby the home country introduces a payroll subsidy (ς_t^P) that is financed by a VAT (τ_t^V).³⁴ With these policies, the marginal revenue of a home country firm selling its product in the domestic market becomes $(1 - \tau_t^V)p_{h,t}$, while its marginal labor cost is equal to $(1 - \varsigma_t^P)w_t$. The marginal revenue of a foreign firm selling its product in the home country is given by $(1 - \tau_t^V)p_{f,t}/q_t$. We assume that the home country firms are not subject to the same VAT in the foreign country and that the foreign country does not retaliate in response to the unilateral adoption of these fiscal measures by the home country. In addition, we assume that the government of the home country uses the mix of these fiscal policies to stabilize the economy using the following Taylor-type fiscal rule:

$$\tau_t^V = \frac{\Delta_t}{1 + \Delta_t}, \quad \text{where } \Delta_t = -\alpha^{FD} \ln \left(\frac{y_t}{y} \right); \quad (\alpha^{FD} > 0).$$

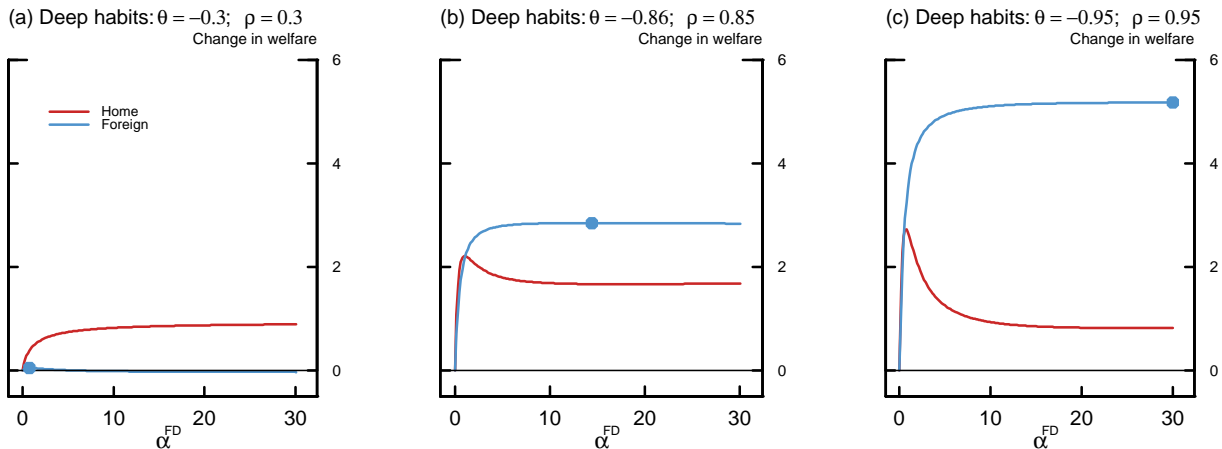
³¹In this region of the parameter space, the monetary union results in a welfare loss even for the foreign country due to the heightened volatility of consumption and hours worked.

³²It is worth emphasizing that the lower joint welfare in the monetary union reported in Table 4 has nothing to do with the possible inefficiency of the posited [Taylor \(1999\)](#) interest-rate rule. As shown in Figure C-1 in Section C of the Appendix, the macroeconomic dynamics in the two countries in response to an asymmetric financial shock in the home country under the Ramsey monetary policy are virtually the same as those under the [Taylor \(1999\)](#) rule, indicating that even the Ramsey planner is unable to overcome the limitations of a one-size-fits-all monetary policy.

³³[Farhi et al. \(2014\)](#) provide an in-depth analysis of various policy mixes that can under various asset market conditions replicate the effects of a given size of nominal exchange rate depreciation. In principle, a complete risk-sharing arrangement that could improve the union’s overall welfare could be achieved by forming a fiscal union, a point emphasized by [Farhi and Werning \(2017\)](#). However, the results reported in Table D-1 in Section D of the Appendix indicate that such a union would likely involve large state-contingent transfers of wealth from the core to the periphery, casting doubt on its political feasibility.

³⁴We stress the qualitative nature of this exercise because the effectiveness of a fiscal devaluation depends importantly on a variety of country-specific factors: the degree of price and wage rigidities, the degree of price pass-through, the elasticity of labor supply, the size of the economy, its trade openness, and the share of labor as variable production input.

FIGURE 10 – Customer Markets and Fiscal Devaluations



NOTE: The lines depict changes in welfare for the home and foreign countries as a function of α^{FD} , the parameter governing the size of a unilateral fiscal devaluation by the home country (see the text for details). The “•” symbol marks the value of α^{FD} that maximizes the welfare of the foreign country. Welfare differentials are measured relative to a baseline monetary union case with no fiscal devaluation—that is, $\alpha^{FD} = 0$.

To pin down the level of the payroll subsidy ζ_t^P , we impose the following revenue-neutrality constraint:

$$\zeta_t^P w_t h_t = \tau_t^V (p_{h,t} c_{h,t} + p_{f,t} c_{f,t}),$$

where the left side represents fiscal expenditures due to the payroll subsidy and the right side is the fiscal revenue generated by the VAT. When the home country slips into a recession, $\Delta_t > 0$, which makes the export sales of foreign country firms and the domestic sales of the home country firms subject to a VAT rate of $\tau_t^V > 0$. At the same time, the revenue-neutrality constraint implies a payroll subsidy $\zeta_t^P > 0$, which lowers the marginal labor cost for home country firms to a fraction $1 - \zeta_t^P$ of the level that prevailed before the implementation of these fiscal measures. Within this framework, we then perform an extensive grid search to find the value of α^{FD} that maximizes the second-order approximation of the value function of the representative household in the foreign country and analyze the effect of such a policy on the welfare of the home country.

In our environment, the goal of a fiscal devaluation is not to recover the resource allocation that would prevail with flexible exchange rates. As noted above, the welfare of the foreign country is lower in a flexible exchange rate regime across most of the (θ, ρ) -space (see the right panel of Figure 9). Hence, the home country cannot carry out a unilateral fiscal devaluation without the fear of retaliation if such a policy recovers the allocation implied by flexible exchange rates. In other words, a unilateral fiscal devaluation by the home country must be carried out in a manner that does not leave the representative foreign household in the monetary union any worse off.

Figure 10 traces out the implications of such an exercise on the welfare of the two countries under three different calibrations of the deep-habit mechanism: “weak” deep habits (panel (a)); baseline deep habits (panel (b)); and “strong” deep habits (panel (c)). In general, this analysis

indicates that the macroeconomic stabilization benefits from a unilateral fiscal devaluation by the home country may be shared by both countries of the union. However, the magnitude of potential welfare gains depends critically, especially for the foreign country, on the strength of customer-market relationships in the two economies.

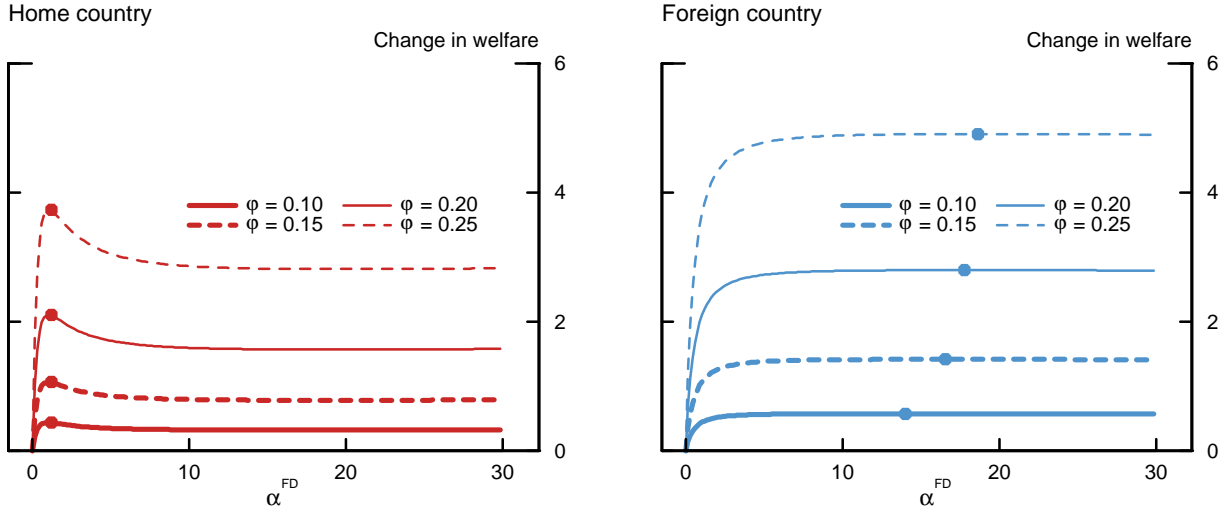
As shown in panel (a), when the strength and persistence of deep habits are fairly weak, the foreign country realizes only a minuscule welfare gain from such a unilateral fiscal devaluation—in fact, too much fiscal activism may result in a small welfare loss for the foreign country. As indicated by the symbol “●,” the foreign welfare reaches the maximum when the home country sets $\alpha^{FD} \approx 1$, and even in this case, the maximal foreign welfare is essentially indistinguishable from the baseline. This result suggests that when foreign firms have relatively little incentive to engage in predatory pricing to capture market share from their home country competitors, it may be difficult for the home country to make a compelling argument for a unilateral fiscal devaluation within the monetary union, even though such a policy is clearly beneficial domestically.

Under our baseline calibration shown in panel (b), by contrast, we reach a very different conclusion. In this case, a fiscal devaluation that maximizes the foreign welfare calls for an aggressive policy setting of $\alpha^{FD} \approx 15$. Even more interestingly, the maximal foreign welfare is attained at the value of α^{FD} that is substantially greater than that preferred by the home country—the latter’s welfare is maximized at $\alpha^{FD} \approx 1$. Thus, with a more powerful deep-habit mechanism, the foreign country has a strong incentive to support an aggressive unilateral fiscal devaluation by the home country. In particular, in the case of the strong deep habits shown in panel (c), there is more room for welfare gains by the foreign country, as that configuration of the deep-habits parameters lies in the region where even the foreign country is worse off in the monetary union.

In both countries, the magnitude of any potential welfare gains (or losses) arising from a unilateral fiscal devaluation by the home country will also depend on the degree of financial market frictions. Because it is the relatively limited capacity of the financial system in the home country that makes the predatory pricing strategies of foreign firms so profitable, we may expect that the greater the degree of financial market imperfections in the home country, the greater are the potential benefits from pursuing a unilateral fiscal devaluation. The left panel of Figure 11 shows the welfare gains from such a fiscal policy for the home country, as we vary the steady-state value of equity dilution costs φ , while the right panel displays the same information for the foreign country. As expected, increasing the severity of financial frictions monotonically increases the welfare gains from a unilateral fiscal devaluation for both countries. Moreover, the optimal degree of fiscal activism by the home country—as measured by the coefficient α^{FD} in the fiscal Taylor rule—also increases, as financial distortions become more severe.

The large fiscal policy reaction coefficient α^{FD} , which is preferred from the perspective of the foreign country under our baseline calibration of the deep-habit mechanism (see panel (b) of Figure 10), does not necessarily imply large changes in the VAT or payroll subsidy rates. Our posited fiscal policy rule—just like the interest-rate rule governing the conduct of monetary policy—responds to an endogenous variable and to the extent that such fiscal measures are effective in stabilizing the

FIGURE 11 – Financial Frictions and Fiscal Devaluations



NOTE: The left (right) panel depicts changes in welfare for the home (foreign) country as a function of α^{FD} , the parameter governing the size of a unilateral fiscal devaluation by the home country, for different values of the steady-state equity dilution costs φ (see the text for details). The “•” symbol in the left panel marks the value of α^{FD} that maximizes the welfare of the home country, while in the right panel, the “•” symbol marks the value of α^{FD} that maximizes the welfare of the foreign country. Welfare differentials are measured relative to a baseline monetary union case with no fiscal devaluation—that is, $\alpha^{FD} = 0$.

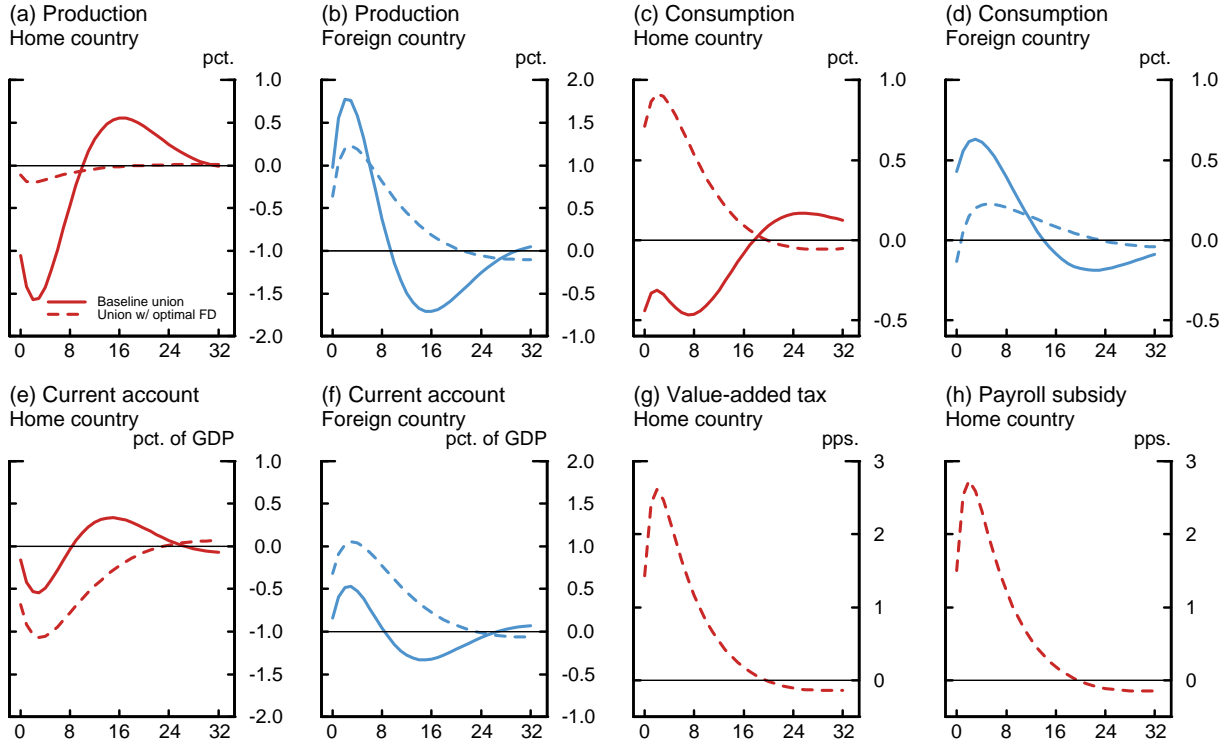
output gap, the effective VAT and payroll subsidy rates will not fluctuate very much in response to changes in the degree of economic slack. A fiscal rule that responds aggressively to the output gap sends a signal to the agents that deviations of real GDP from its potential will be countered by large changes in the tax and subsidy rates. Because such a policy is credible, effective rates do not need to change much in equilibrium and do not result in overly protectionist trade policy.

Figure 12 illustrates this point in the context of our standard asymmetric financial shock in the home country. The solid lines show the impulse responses of selected variables from the simulation reported in Figure 4, a situation where the countries share a common currency and monetary policy. The dotted lines show the corresponding responses in the case when the home country responds to the shock by engaging in a unilateral fiscal devaluation that maximizes the foreign country’s welfare. Despite the large reaction coefficient α^{FD} implied by such policy, the home country needs to increase the VAT and payroll subsidy rates only about 2.5 percentage points in response to the financial disturbance (panels (g) and (h)).³⁵

Panels (e) and (f) show that this policy actually boosts trade between the two countries, despite the loss of competitiveness by foreign firms engendered by the increase in the domestic VAT rate and the introduction of the payroll subsidy for home country firms. In effect, this relatively modest unilateral fiscal devaluation by the home country is very effective in stabilizing domestic production (panel (a)) and provides significant stimulus for consumption (panel (c)). As a result, the home

³⁵We assume that both rates are equal to zero in the steady state.

FIGURE 12 – Optimal Fiscal Devaluation



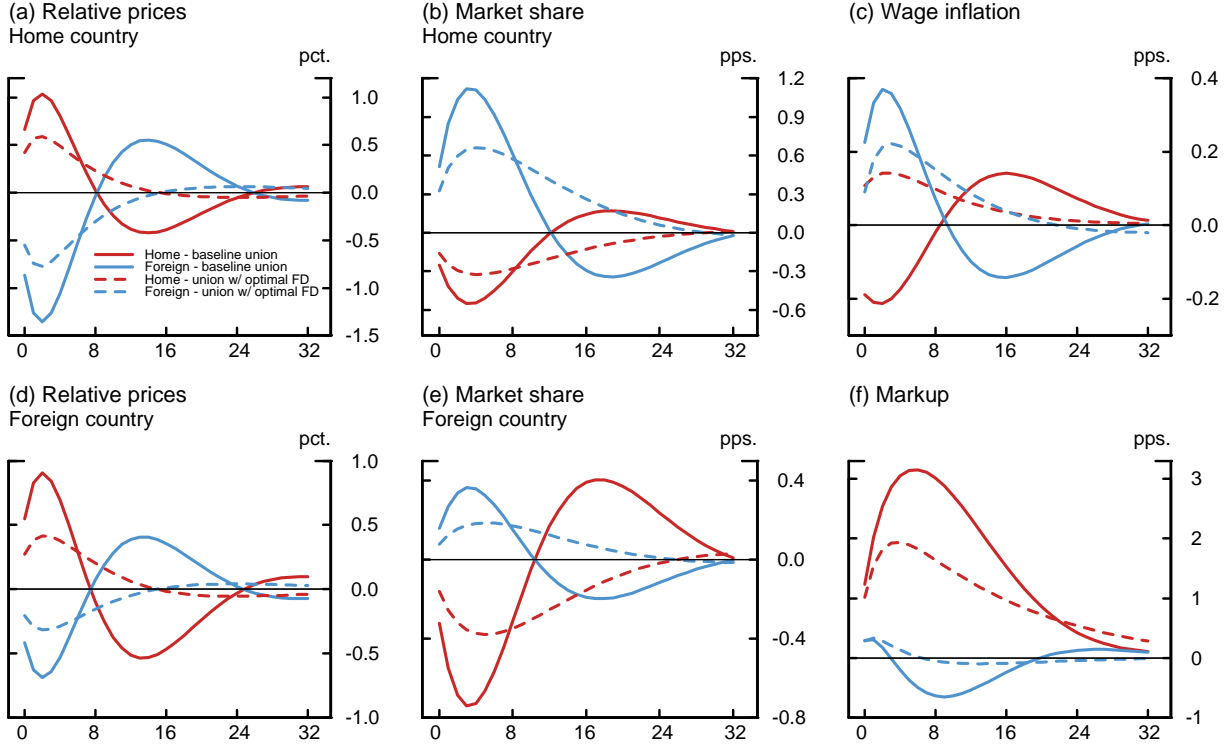
NOTE: The solid lines depict the model-implied responses of selected variables to an adverse financial shock in the home country in period 0, when the two countries are in a monetary union (see Figure 4). The dashed lines show the corresponding responses when the home country pursues a unilateral fiscal devaluation, with the fiscal reaction coefficient α^{FD} that maximizes the welfare of the foreign country; see the text for details.

country’s current account deficit actually increases relative to the baseline monetary union case. From the vantage point of the home country, this additional volatility of consumption and current account is likely to be suboptimal, as the fiscal policy rule seeks to optimize the welfare of the foreign country in this simulation.³⁶

To examine the economic mechanism behind the macroeconomic stabilization properties of such a fiscal devaluation, Figure 13 shows the dynamics—implied by our standard asymmetric financial shock—of relative prices, market shares, wages, and markups in the two countries of the monetary union, when the home country engages in a unilateral fiscal devaluation. The dashed lines show the responses with the fiscal devaluation, while the solid lines show the corresponding responses in the baseline monetary union case of no fiscal devaluation (see the solid lines in Figure 6). The comparison of dashed responses in panels (a), (b), (d), and (e) of Figure 13 with the corresponding dashed responses in Figure 6 reveals that such a fiscal devaluation stabilizes relative prices and

³⁶To conserve space, we do not show the results for the case when the fiscal policy rule seeks to maximize the welfare of the home country. These results, which are available upon request, indeed indicate that the fiscal devaluation reported in Figure 12 generates excessive volatility of domestic consumption and current account, compared with the policy that is optimal from the perspective of the home country.

FIGURE 13 – Financial Shock, International Price War, and Optimal Fiscal Devaluation



NOTE: The panels of the figure depict the model-implied responses of selected variables to an adverse financial shock in the home country in period 0, when the two countries are in a monetary union (see Figure 6). The dashed lines show the corresponding responses when the home country pursues a unilateral fiscal devaluation, with the fiscal reaction coefficient α^{FD} that maximizes the welfare of the foreign country; see the text for details.

markets shares in both the domestic and foreign markets to a degree similar to that realized under flexible exchange rates. The manner through which this stabilization is achieved, however, differs markedly between the two cases.

To understand this difference, it is useful to recall the definition of the equity issuance threshold, a_t^E , given in equation (17); recall that the higher this threshold, the lower is the likelihood that firms will have to issue new equity. From the definition of a_t^E , it is also clear that raising relative prices in response to a financial shock allows home country firms to reduce the likelihood of having to resort to costly external finance when the two countries share a common currency. Note also that with flexible exchange rates, home country firms do not need to raise relative prices as much because the depreciation of the real exchange rate—the increase in q_t —improves their internal liquidity positions.

The introduction of a fiscal devaluation by the home country modifies the equity issuance threshold as

$$a_t^E = \frac{A_t}{(1 - \varsigma_t^P)w_t} \left[\frac{p_{h,t}(1 - \tau_t^Y)c_{h,t} + q_t p_{h,t}^* c_{h,t}^*}{(\phi + c_{h,t} + c_{h,t}^*)^{\frac{1}{\alpha}}} \right].$$

Clearly, an increase in the payroll subsidy ς_t^P improves the firms' internal liquidity positions, while raising the VAT rate τ_t^V worsens their liquidity positions. However, because the VAT is applied only to the domestic sales, whereas the payroll subsidy affects the entire wage bill, the improvement in the firms' liquidity positions resulting from the payroll subsidy outweighs the negative impact of the VAT. As a result, home country firms do not have to raise relative prices as much as they are forced to do so in the baseline monetary union case without a fiscal devaluation.³⁷

These effects can be seen in panel (f) of Figure 13. The financial support engendered by the payroll subsidy improves the internal liquidity positions of firms in the home country, which given the consideration of their long-run market shares, allows them to choose lower markups (and relative prices). Furthermore, foreign firms do not engage in the same degree of predatory pricing as in the baseline case because such behavior would lower their after-tax revenue by too much. In effect, the mix of the VAT and payroll subsidy in the home country reduces the degree of financial heterogeneity in the union and results in a better economic outcome for the union as a whole.

As can be seen by comparing the home country's production and consumption trajectories under flexible exchange rates (Figure 5) with those from the monetary union with a unilateral fiscal devaluation (Figure 12), the two experiments yield rather similar dynamics when the home country is hit by a financial shock. This similarity, however, masks important difference in the behavior of the current account during the ensuing financial crisis. With flexible exchange rates, the real exchange rate depreciation boosts the home country firms' exports, which alleviates the severity of liquidity constraint. As a result of the export boom, the home country registers a modest improvement in its current account. In the fiscal devaluation case, by contrast, the real exchange rate appreciates as the home country's external position deteriorates notably in the aftermath of the financial shock.

Assuming that a breakup of the union—and the return to flexible exchange rates—is not politically feasible, a unilateral fiscal devaluation by the home country thus cannot stabilize the contraction in the home country's output by engineering an export boom. This fiscal policy mix achieves macroeconomic stabilization in the face of a large financial disruption by further increasing the home country's current account deficit, rather than by turning the deficit into surplus, which would require a sizable reduction in consumption. As shown in panel (c) of Figure 12, consumption in the home country declines notably in the baseline monetary union case, whereas the unilateral fiscal devaluation leads to an increase in consumption, driven primarily by an increase in the consumption of domestically produced goods.

These results have important implications for the type of macroeconomic stabilization policies prescribed to countries experiencing a balance-of-payment crisis within a monetary union. If a return to flexible exchange rates is not a viable political option, the conventional prescription of fiscal austerity that will turn the current account deficit into surplus may be suboptimal. In our environment, allowing the country in crisis to borrow in international capital markets helps to

³⁷If this mix of fiscal policies is not constrained by revenue neutrality and the home country can run a temporary fiscal deficit, such a unilateral fiscal devaluation can provide even greater liquidity support to home country firms.

stabilize not only its economy, but also improves the welfare of the lender country.

The results in this section may seem counterintuitive at first glance. Why would the representative foreign household benefit from a unilateral fiscal devaluation by the home country, when such a policy weakens the competitiveness of foreign firms, especially as these firms are aggressively pursuing profit-maximizing pricing strategies that build their customer base? The answer lies in the fact that the interaction of customer markets and financial frictions creates an important pecuniary externality in our model: When foreign firms reduce markups at the time when home country firms are experiencing financial distress, they treat aggregate prices and quantities as given—that is, foreign firms do not internalize the effects of their pricing behavior on aggregate demand in their own country. Consequently, foreign firms reduce markups to excessively low levels, behavior that is individually rational, but one that does not take into account the fact that driving out their home country competitors will increase macroeconomic volatility in their own country.

The overly aggressive predatory pricing behavior of foreign firms limits the welfare gains for the foreign country. As shown in the bottom panel of Table 4, joining the monetary union increases the average level of consumption in the foreign country by 1 percent. Despite this economically large gain in the steady-state consumption level, the welfare gain for the representative foreign household—in terms of the certainty-equivalent changes in the average consumption—amounts to only 0.11 percent. This is because joining the union significantly increases the volatility of consumption—and especially of hours worked—in the foreign country. A unilateral fiscal devaluation by the home country effectively removes these deleterious welfare side-effects without eliminating the sizable steady-state gains in foreign consumption. According to our calculations, the volatility of foreign consumption is reduced by two-thirds—relative to the baseline monetary union case—as a result of the fiscal devaluation by the home country, while the volatility of hours worked declines by almost 40 percent. Such large reductions in the variabilities of consumption and hours worked result in the first-order welfare gain for the foreign country, a gain that is not internalized by foreign firms in the absence of a fiscal devaluation by the home country.

7 Conclusion

In this paper, we present a dynamic, two-country general equilibrium model and use it to analyze the business cycle and welfare consequences of forming a monetary union among countries, whose financial markets are subject to varying degrees of distortions. Because of customer-market considerations, financial shocks affect the firms' pricing decisions, thereby influencing the dynamics of markups and market shares—and therefore patterns of external adjustment—across countries.

When applied to the eurozone crisis, the interaction of customer markets and financial frictions helps explain several phenomena that are difficult to reconcile using conventional models. First, the pricing mechanism implied by this interaction is consistent with our empirical evidence, which shows that the tightening of financial conditions in the euro area periphery between 2008 and 2013 significantly attenuated the downward pressure on prices arising from the emergence of substantial

and long-lasting economic slack. And second, this tightening of financial conditions is strongly associated with an increase in price markups in the periphery. Hence our framework can explain why the periphery countries have managed to avoid a debt-deflation spiral in the face of persistent economic weakness and high indebtedness and how the price war between the core and periphery has impeded the adjustment process through which the latter economies have been trying to regain external competitiveness.

In our model, the pricing behavior of firms in the core in response to a financial shock in the periphery implies a real exchange rate depreciation vis-à-vis the periphery, which causes an export-driven boom in the core and a deepening of the recession in the periphery. The one-size-fits-all aspect of monetary policy in a common currency regime is especially ill-suited to address such divergent economic outcomes. When the union countries are experiencing different economic conditions, common monetary policy aimed at stabilizing inflation and output fluctuations results in a substantially higher macroeconomic volatility compared with flexible exchange rates. This translates into a welfare loss for the union as a whole, with the loss borne entirely by the periphery.

To overcome limitations of common monetary policy, we consider the effects of a unilateral fiscal devaluation by the periphery. The results indicate that such policies offer an effective macroeconomic stabilization tool that, in general, is beneficial even to the core. This finding reflects the fact that when firms in the core reduce markups to expand their market shares, they do not internalize the pecuniary externality, whereby driving out their foreign competitors by reducing markups to an excessive degree leads to excessive volatility of aggregate demand in their own country. A distortionary taxation in the form a unilateral fiscal devaluation by the periphery helps firms from the core internalize this externality, leading to an improvement in the union's overall welfare.

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Appendix

A Optimal Pricing

This section derives the firm's optimal pricing strategies in the domestic and foreign markets, given by equations (18) and (19) in the main text. Given the symmetric nature of the profit-maximization problems faced by home and foreign firms, we present the pricing rules from the vantage point of a firm in the home country. The full set of first-order conditions implied by the optimization of the Lagrangian (12) in the main text is given by:

With respect to $d_{i,t}$:

$$\xi_{i,t} = \begin{cases} 1 & \text{if } d_{i,t} \geq 0; \\ 1/(1 - \varphi) & \text{if } d_{i,t} < 0. \end{cases} \quad (\text{A-1})$$

With respect to $h_{i,t}$:

$$\xi_{i,t} w_t = \alpha \kappa_{i,t} \left(\frac{A_t}{a_{i,t}} h_{i,t} \right)^{\alpha-1}, \quad (\text{A-2})$$

where the conditional demand for labor is given by

$$h_{i,t} = \frac{a_{i,t}}{A_t} (\phi + c_{i,h,t} + c_{i,h,t}^*)^{\frac{1}{\alpha}}. \quad (\text{A-3})$$

With respect to $c_{i,h,t}$ and $c_{i,h,t}^*$:

$$\mathbb{E}_t^a[\nu_{i,h,t}] = \mathbb{E}_t^a[\xi_{i,t}] p_{i,h,t} p_{h,t} - \mathbb{E}_t^a[\kappa_{i,t}] + (1 - \rho) \lambda_{i,h,t}; \quad (\text{A-4})$$

$$\mathbb{E}_t^a[\nu_{i,h,t}^*] = \mathbb{E}_t^a[\xi_{i,t}] q_t p_{i,h,t}^* p_{h,t}^* - \mathbb{E}_t^a[\kappa_{i,t}] + (1 - \rho) \lambda_{i,h,t}^*. \quad (\text{A-5})$$

With respect to $s_{i,h,t}$ and $s_{i,h,t}^*$:

$$\lambda_{i,h,t} = \rho \mathbb{E}_t[m_{t,t+1} \lambda_{i,h,t+1}] + \theta(1 - \eta) \mathbb{E}_t \left[m_{t,t+1} \mathbb{E}_{t+1}^a \left[\nu_{i,h,t+1} \frac{c_{i,h,t+1}}{s_{i,h,t}} \right] \right]; \quad (\text{A-6})$$

$$\lambda_{i,h,t}^* = \rho \mathbb{E}_t[m_{t,t+1} \lambda_{i,h,t+1}^*] + \theta(1 - \eta) \mathbb{E}_t \left[m_{t,t+1} \mathbb{E}_{t+1}^a \left[\nu_{i,h,t+1}^* \frac{c_{i,h,t+1}^*}{s_{i,h,t}^*} \right] \right]. \quad (\text{A-7})$$

With respect to $p_{i,h,t}$ and $p_{i,h,t}^*$:

$$\begin{aligned} \eta \frac{\mathbb{E}_t^a[\nu_{i,h,t}]}{p_{i,h,t}} c_{i,h,t} &= \mathbb{E}_t^a[\xi_{i,t}] \left[p_{h,t} c_{i,h,t} - \gamma_p \frac{\pi_{h,t}}{p_{i,h,t-1}} \left(\pi_{h,t} \frac{p_{i,h,t}}{p_{i,h,t-1}} - 1 \right) c_t \right] \\ &+ \gamma_p \mathbb{E}_t \left[m_{t,t+1} \mathbb{E}_{t+1}^a[\xi_{i,t+1}] \pi_{h,t+1} \frac{p_{i,h,t+1}}{p_{i,h,t}^2} \left(\pi_{h,t+1} \frac{p_{i,h,t+1}}{p_{i,h,t}} - 1 \right) c_{t+1} \right]; \end{aligned} \quad (\text{A-8})$$

$$\begin{aligned} \eta \frac{\mathbb{E}_t^a[\nu_{i,h,t}^*]}{p_{i,h,t}^*} c_{i,h,t}^* &= \mathbb{E}_t^a[\xi_{i,t}] \left[q_t p_{h,t}^* c_{i,h,t}^* - \gamma_p \frac{q_t \pi_{h,t}^*}{p_{i,h,t-1}^*} \left(\pi_{h,t}^* \frac{p_{i,h,t}^*}{p_{i,h,t-1}^*} - 1 \right) c_t^* \right] \\ &+ \gamma_p \mathbb{E}_t \left[m_{t,t+1} \mathbb{E}_{t+1}^a[\xi_{i,t+1}] q_{t+1} \pi_{h,t+1}^* \frac{p_{i,h,t+1}^*}{p_{i,h,t}^{*2}} \left(\pi_{h,t+1}^* \frac{p_{i,h,t+1}^*}{p_{i,h,t}^*} - 1 \right) c_{t+1}^* \right] \end{aligned} \quad (\text{A-9})$$

In the absence of nominal price rigidities, the first-order conditions (A-8) and (A-9) reduce to

$$p_{i,h,t} p_{h,t} = \eta \frac{\mathbb{E}_t^a[\nu_{i,h,t}]}{\mathbb{E}_t^a[\xi_{i,t}]}; \quad (\text{A-10})$$

and

$$q_t p_{i,h,t}^* p_{h,t}^* = \eta \frac{\mathbb{E}_t^a[\nu_{i,h,t}^*]}{\mathbb{E}_t^a[\xi_{i,t}]}; \quad (\text{A-11})$$

Dividing the first-order conditions (A-4) and (A-5) by the expected shadow value of internal funds yields

$$\frac{\mathbb{E}_t^a[\nu_{i,h,t}]}{\mathbb{E}_t^a[\xi_{i,t}]} = p_{i,h,t} p_{h,t} - \frac{\mathbb{E}_t^a[\kappa_{i,t}]}{\mathbb{E}_t^a[\xi_{i,t}]} + (1 - \rho) \frac{\lambda_{i,h,t}}{\mathbb{E}_t^a[\xi_{i,t}]}; \quad (\text{A-12})$$

and

$$\frac{\mathbb{E}_t^a[\nu_{i,h,t}^*]}{\mathbb{E}_t^a[\xi_{i,t}]} = q_t p_{i,h,t}^* p_{h,t}^* - \frac{\mathbb{E}_t^a[\kappa_{i,t}]}{\mathbb{E}_t^a[\xi_{i,t}]} + (1 - \rho) \frac{\lambda_{i,h,t}^*}{\mathbb{E}_t^a[\xi_{i,t}]}; \quad (\text{A-13})$$

Similarly, dividing the first-order-conditions (A-6) and (A-7) by the expected shadow value of internal funds we obtain

$$\begin{aligned} \frac{\lambda_{i,h,t}}{\mathbb{E}_t^a[\xi_{i,t}]} &= \rho \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \frac{\lambda_{i,h,t+1}}{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]} \right] \\ &+ \theta(1 - \eta) \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \frac{\mathbb{E}_{t+1}^a[\nu_{i,h,t+1}]}{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]} \frac{c_{i,h,t+1}}{s_{i,h,t}} \right]; \end{aligned} \quad (\text{A-14})$$

and

$$\begin{aligned} \frac{\lambda_{i,h,t}^*}{\mathbb{E}_t^a[\xi_{i,t}]} &= \rho \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \frac{\lambda_{i,h,t+1}^*}{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]} \right] \\ &+ \theta(1 - \eta) \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \frac{\mathbb{E}_{t+1}^a[\nu_{i,h,t+1}^*]}{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]} \frac{c_{i,h,t+1}^*}{s_{i,h,t}^*} \right]. \end{aligned} \quad (\text{A-15})$$

Updating equations (A-12) and (A-13) one period and substituting the resulting expressions into the right-hand sides of equations (A-14) and (A-15), we obtain

$$\begin{aligned} \frac{\lambda_{i,h,t}}{\mathbb{E}_t^a[\xi_{i,t}]} &= \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \left(\rho + \theta(1 - \eta)(1 - \rho) \frac{c_{i,h,t+1}}{s_{i,h,t}} \right) \frac{\lambda_{i,h,t+1}}{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]} \right] \\ &+ \theta(1 - \eta) \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \frac{c_{i,h,t+1}}{s_{i,h,t}} \mathbb{E}_{t+1}^a \left[\left(p_{i,h,t+1} p_{h,t+1} - \frac{\mathbb{E}_{t+1}^a[\kappa_{i,t+1}]}{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]} \right) \right] \right]; \end{aligned} \quad (\text{A-16})$$

and

$$\begin{aligned} \frac{\lambda_{i,h,t}^*}{\mathbb{E}_t^a[\xi_{i,t}]} &= \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \left(\rho + \theta(1 - \eta)(1 - \rho) \frac{c_{i,h,t+1}^*}{s_{i,h,t}^*} \right) \frac{\lambda_{i,h,t+1}^*}{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]} \right] \\ &+ \theta(1 - \eta) \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \frac{c_{i,h,t+1}^*}{s_{i,h,t}^*} \mathbb{E}_{t+1}^a \left[\left(q_{t+1} p_{i,h,t+1}^* p_{h,t+1}^* - \frac{\mathbb{E}_{t+1}^a[\kappa_{i,t+1}]}{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]} \right) \right] \right]. \end{aligned} \quad (\text{A-17})$$

We then impose the symmetric equilibrium conditions, $c_{i,h,t+1} = c_{h,t+1}$, $s_{i,h,t} = s_{h,t}$, $\lambda_{i,h,t} = \lambda_{h,t}$, $p_{i,h,t+1} = 1$, $c_{i,h,t+1}^* = c_{h,t+1}^*$, $s_{i,h,t}^* = s_{h,t}^*$, $\lambda_{i,h,t}^* = \lambda_{h,t}^*$, and $p_{i,h,t+1}^* = 1$, for all i , to obtain

$$\begin{aligned} \frac{\lambda_{h,t}}{\mathbb{E}_t^a[\xi_{i,t}]} &= \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \left(\rho + \theta(1-\eta)(1-\rho) \frac{s_{h,t+1}/s_{h,t} - \rho}{1-\rho} \right) \frac{\lambda_{h,t+1}}{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]} \right] \\ &+ \theta(1-\eta) \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \frac{s_{h,t+1}/s_{h,t} - \rho}{1-\rho} \mathbb{E}_{t+1}^a \left[\left(p_{h,t+1} - \frac{1}{\tilde{\mu}_{t+1}} \right) \right] \right]; \end{aligned} \quad (\text{A-18})$$

and

$$\begin{aligned} \frac{\lambda_{h,t}^*}{\mathbb{E}_t^a[\xi_{i,t}]} &= \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \left(\rho + \theta(1-\eta)(1-\rho) \frac{s_{h,t+1}^*/s_{h,t}^* - \rho}{1-\rho} \right) \frac{\lambda_{h,t+1}^*}{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]} \right] \\ &+ \theta(1-\eta) \mathbb{E}_t \left[m_{t,t+1} \frac{\mathbb{E}_{t+1}^a[\xi_{i,t+1}]}{\mathbb{E}_t^a[\xi_{i,t}]} \frac{s_{h,t+1}^*/s_{h,t}^* - \rho}{1-\rho} \mathbb{E}_{t+1}^a \left[\left(q_{t+1} p_{h,t+1}^* - \frac{1}{\tilde{\mu}_{t+1}} \right) \right] \right], \end{aligned} \quad (\text{A-19})$$

where we used the fact that $c_{h,t+1}/s_{h,t} = (s_{h,t+1}/s_{h,t} - \rho)/(1-\rho) \equiv g_{h,t+1}$, $c_{h,t+1}^*/s_{h,t}^* = (s_{h,t+1}^*/s_{h,t}^* - \rho)/(1-\rho) \equiv g_{h,t+1}^*$, and $\mathbb{E}_{t+1}^a[\kappa_{i,t+1}]/\mathbb{E}_{t+1}^a[\xi_{i,t+1}] = \tilde{\mu}_{t+1}^{-1}$. We can define the growth-adjusted, compounded discount factors, $\beta_{h,t,s}$ and $\beta_{h,t,s}^*$, as

$$\beta_{h,t,s} = \begin{cases} m_{s-1,s} g_{h,s} & \text{if } s = t+1; \\ m_{s-1,s} g_{h,s} \times \prod_{j=1}^{s-(t+1)} (\rho + \chi g_{h,t+j}) m_{t+j-1,t+j} & \text{if } s > t+1; \end{cases} \quad (\text{A-20})$$

$$\beta_{h,t,s}^* = \begin{cases} m_{s-1,s} g_{h,s}^* & \text{if } s = t+1; \\ m_{s-1,s} g_{h,s}^* \times \prod_{j=1}^{s-(t+1)} (\rho + \chi g_{h,t+j}^*) m_{t+j-1,t+j} & \text{if } s > t+1, \end{cases} \quad (\text{A-21})$$

where $\chi = \theta(1-\eta)(1-\rho)$.

Rational expectations solutions to equations (A-18) and (A-19) can then be found by iterating the two equations forward as

$$\frac{\lambda_{h,t}}{\mathbb{E}_t^a[\xi_{i,t}]} = \theta(1-\eta) \mathbb{E}_t \left[\sum_{s=t+1}^{\infty} \beta_{h,t,s} \frac{\mathbb{E}_s^a[\xi_{i,s}]}{\mathbb{E}_t^a[\xi_{i,t}]} \left(p_{h,s} - \frac{1}{\tilde{\mu}_s} \right) \right]; \quad (\text{A-22})$$

and

$$\frac{\lambda_{h,t}^*}{\mathbb{E}_t^a[\xi_{i,t}]} = \theta(1-\eta) \mathbb{E}_t \left[\sum_{s=t+1}^{\infty} \beta_{h,t,s}^* \frac{\mathbb{E}_s^a[\xi_{i,s}]}{\mathbb{E}_t^a[\xi_{i,t}]} \left(q_s p_{h,s}^* - \frac{1}{\tilde{\mu}_s} \right) \right]. \quad (\text{A-23})$$

After imposing the symmetric equilibrium conditions, we substitute equations (A-12) and (A-13) into equations (A-10) and (A-11), which yields

$$p_{h,t} = \eta p_{h,t} - \eta \frac{1}{\tilde{\mu}_t} + (1-\rho) \eta \frac{\lambda_{h,t}}{\mathbb{E}_t^a[\xi_{i,t}]}; \quad (\text{A-24})$$

and

$$q_t p_{h,t}^* = \eta q_t p_{h,t}^* - \eta \frac{1}{\tilde{\mu}_t} + (1-\rho) \eta \frac{\lambda_{h,t}^*}{\mathbb{E}_t^a[\xi_{i,t}]} \quad (\text{A-25})$$

Finally, substituting equations (A-22) and (A-23) into equations (A-24) and (A-25) and solving the resulting expressions for $p_{h,t}$ and $q_t p_{h,t}^*$ yields the firm's optimal pricing strategies in the domestic and foreign markets, given by equations (18) and (19) in the main text.

B Calibration Summary

The entries in the table denote the values of the model parameters used in the baseline calibration of the model.

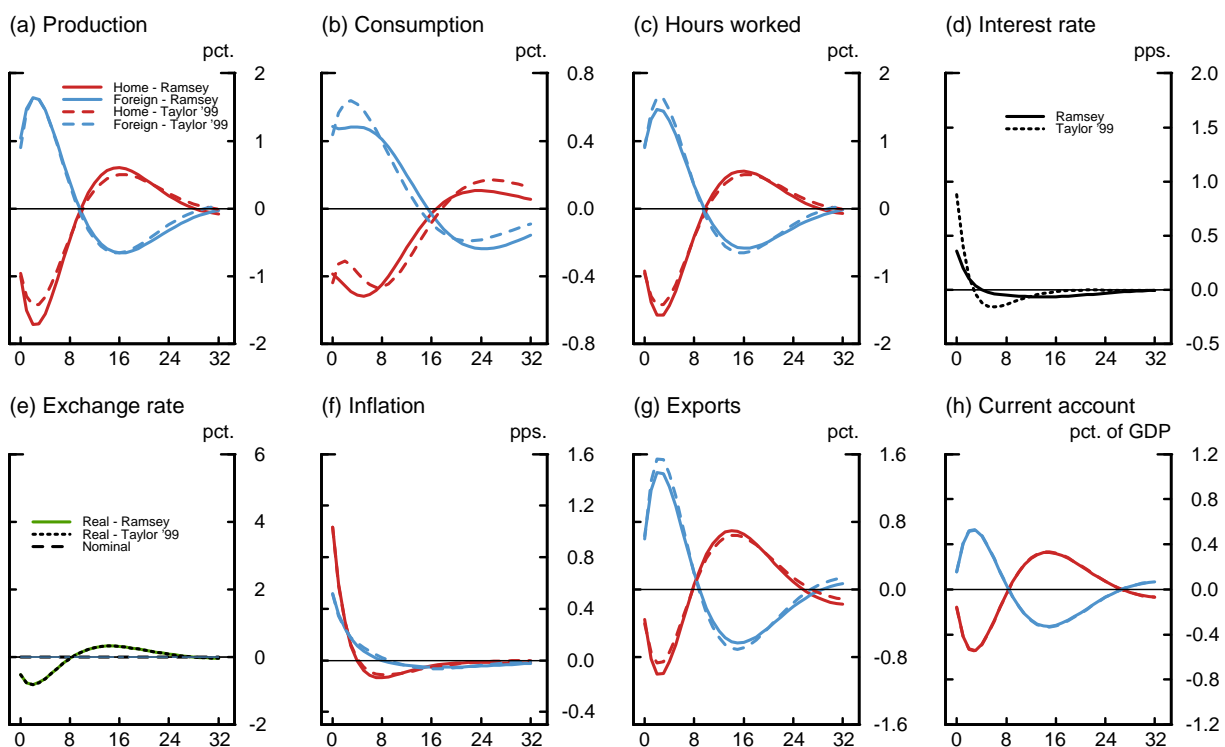
TABLE B-1 – Baseline Calibration

Model Parameters	Value
<i>Preferences & technology</i>	
time discount factor (δ)	0.996
constant relative risk aversion (γ_x)	2.000
elasticity of labor supply (ζ)	5.000
elasticity of substitution between differentiated labor (η_w)	2.000
strength of deep habits (θ)	-0.860
persistence of deep habits (ρ)	0.850
elasticity of substitution between differentiated goods (η)	2.000
Armington elasticity (ε)	1.500
home bias ($\Xi_h^\varepsilon, \Xi_f^{*\varepsilon}$)	(0.600, 0.600)
returns-to-scale (α)	1.000
fixed operating costs (ϕ, ϕ^*)	(0.10, 0.10)
<i>Nominal rigidities & monetary policy</i>	
price adjustment costs (γ_p)	10.00
wage adjustment costs (γ_w)	30.00
Taylor rule inflation gap coefficient (ψ_π)	1.500
Taylor rule output gap coefficient (ψ_y)	1.000
<i>Financial frictions & shocks</i>	
equity dilution costs (φ, φ^*)	(0.20, 0.02)
std. deviation of idiosyncratic cost shock (σ)	0.200
portfolio rebalancing costs (τ)	0.150
persistence of aggregate financial shocks (ρ_f)	0.900
persistence of aggregate technology shocks (ρ_A)	0.900
persistence of aggregate demand shocks (ρ_ω)	0.900

C Optimal Monetary Policy in the Monetary Union

As noted in the main text, the welfare calculations for the monetary union reported in Table 4 are not predicated on optimal monetary policy because we assume that the union's central bank conducts monetary policy according to the Taylor (1999) interest-rate rule. To show that the lower joint welfare in the monetary union is not due to the suboptimality of the assumed interest-rate rule, the solid lines in Figure C-1 depict the responses of selected variables to our standard asymmetric financial shock in the home country in the case of optimal monetary policy conducted by the Ramsey planner, whose objective is to maximize the joint welfare of the two countries using a union-wide short-term interest rate; for comparison purposes, the dashed lines show the corresponding responses from the baseline monetary union experiment, in which the monetary authorities follow the Taylor (1999) interest-rate rule (see Figure 4). The fact that the dynamics of key macroeconomic aggregates are virtually the same across these two simulations indicates that even the Ramsey planner is unable to overcome the limitations of a one-size-fits-all aspect of monetary policy in the monetary union.

FIGURE C-1 – Financial Shock in the Monetary Union With Optimal Monetary Policy



NOTE: The solid lines depict the model-implied responses of selected variables to an adverse financial shock in the home country in period 0, when the two countries are in a monetary union and monetary policy is conducted by the Ramsey planner. The dashed lines show the corresponding responses when the union-wide monetary policy follows the Taylor (1999) interest-rate rule; see the text for details.

D Welfare Consequences of a Fiscal Union

Table D-1 compares the representative households' welfare—with and without risk sharing—when the two countries share a common currency. Under our baseline calibration shown in panel (a), both countries can potentially reap large welfare gains by forming a fiscal union, according to the certainty-equivalent changes in consumption, which are required to make the welfare levels of the households in the monetary union with risk sharing equal to those in the union without risk sharing. As shown in panel (b), the potential welfare gains from forming a fiscal union are even larger with very strong and persistent deep habits, an environment where the interaction between customer markets and financial distortions leads to an especially powerful propagation of financial shocks when the two countries share a common currency. Recall that this configuration of θ and ρ lies in the region of parameter space that is associated with a lower welfare for the foreign country in a monetary union (see Figure 9 in the main text). Thus in these more extreme circumstances, the macroeconomic stabilization properties of a fiscal union may also confer significant benefits on the financially strong members of the union.

TABLE D-1 – Welfare Consequences of Forming a Fiscal Union

Calibration	Welfare Comparison		CE (pct.)
	w/o Risk Sharing	w/ Risk Sharing	
(a) $\theta = -0.86, \rho = 0.85, \phi^* = \phi$			
Home country	-259.23	-257.61	0.79
Foreign country	-254.05	-253.15	0.45
<i>Memo:</i> Both countries	-513.28	-510.76	.
(b) $\theta = -0.95, \rho = 0.95, \phi^* = \phi$			
Home country	-283.64	-279.86	1.71
Foreign country	-278.47	-274.94	1.66
<i>Memo:</i> Both countries	-562.11	-554.80	.
(c) $\theta = -0.86, \rho = 0.85, \phi^* = 0.9\phi$			
Home country	-261.00	-254.69	3.13
Foreign country	-248.73	-249.81	-0.56
<i>Memo:</i> Both countries	-509.73	-504.50	.

NOTE: CE denotes the certainty-equivalent change in the average consumption per period (holding hours worked constant) that is required to make the representative household in the specified country no worse off when the two countries in the monetary union abandon a complete risk-sharing arrangement. In panels (a) and (b), $\phi^* = \phi = 0.1$, as in our baseline calibration.

The calibration in panel (c), by contrast, indicates that the formation of a fiscal union when the two countries already share a common currency—a progression envisioned by the European political establishment—is not necessarily Pareto improving. This calibration differs from our baseline in only one dimension: We assume that foreign firms are slightly more efficient—in terms of fixed operating costs—than their domestic counterparts; that is, $\phi^* = 0.9\phi$, where $\phi = 0.1$, our baseline value. In this case, the welfare of the foreign country is significantly lower with complete risk sharing, according to the certainty-equivalent consumption metric.

A useful way to think about this result is to interpret the fixed operating costs as capturing the quality of the firms' balance sheets. That is, these costs can include long-term debt payments, a coupon payment to perpetual bond holders and can thus capture the possibility of a debt overhang.

Under this interpretation, the country with high fixed operating costs can be viewed as highly indebted, as is the eurozone periphery; for instance, the debt-to-GDP ratio averaged 130 percent in the eurozone periphery in 2013, about 55 percentage points higher than the corresponding average for the core. In our model, this differential translates into $\phi^* = 0.6\phi$, and our welfare calculations imply that the representative foreign household would see its steady-state consumption level decline 7 percent per quarter in the fiscal union, compared with a situation in which the two countries only share a common currency. By the same token, the representative home country household would see an increase of 9 percent in certainty-equivalent consumption were the two countries form a fiscal union. While admittedly crude, these welfare calculations underscore the political difficulties of forming a fiscal union, as residents of the foreign country are unlikely to agree with the size of such wealth transfers.