Exit Expectations, Time Inconsistency, and the Optimal Design of a Currency Union

Yuta Saito (Kobe International University)

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Model

Scenario:
- Advanced countries belong to a currency union (CU)
- They decide the number of developing countries in the CU.

Motive for belonging to the CU:
- Having a domestic central bank yields inflation bias.
- Joining the CU enhances the credibility of monetary policy.

Policymaking in the CU: Majority voting

Originality of the paper: An exogenous rise of expectations of advanced countries’ exits from the CU.

Finding

Exit expectations↑
→ Optimal number of developing countries↑
→ Members under heterogeneous economic conditions↑
(≠ Mundell’s criterion of the optimal currency area)