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Coalition formation in international monetary policy games

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Abstract

This paper analyses coalition formation in monetary policy coordination games between n countries. We show that some but not all countries may join if the decision to be a member of the coalition is incentive-compatible for the individual country. Positive spillovers of the coalition formation process and the resulting free-rider problem limit the stable coalition size: since the coalition members are bound by the union's discipline, an outsider can successfully export inflation without fearing that the insiders will try to do the same. These 'gains from staying out' arise even in the case of symmetric shocks. © 2002 Elsevier Science B.V. All rights reserved.

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The economic debate on which countries should join a monetary union has often focused on 'who should be let in' rather than 'who wants to join'. However, three members of the European Union — Denmark, the UK and Sweden — decided not to join the European Monetary Union from the beginning: the gains from joining the union may not outweigh the costs. This paper focuses on one type of gain from joining a union only, the gain that arises from coordination of monetary policies after a common shock. We draw attention to some reasons for why a country may

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want to stay out, despite the existence of inefficiencies from non-coordinated policies.

In the model by Canzoneri and Henderson (1991) after a negative supply shock countries try to export inflation via an appreciation of the exchange rate. Without cooperation, because all countries are doing so, none of them succeed but they all have contracted their money supply too much. This provides the 'classical' argument for the benefits from coordination in Hamada's (1976) seminal article: all countries could do better by agreeing not to try to export inflation.

However, the situation changes when there are some countries that join a union while others remain outside. Since the union members are now bound by the coalition's discipline, an outsider can successfully export inflation without fearing that the insiders try to do the same. These additional 'gains from staying out' are the reason why the largest stable coalition comprises some but not all countries, even in the case of symmetric shocks. We find over a large range of parameter values that in our model only three countries want to join such a union.

The paper here focuses on *one* type of cost only: the possibility of free-riding on the coalition's discipline when remaining outside. This complements existing research in a number of ways and provides important insights into the feasibility of coalition formations and therefore the European Monetary Union.

Asymmetries are often seen as the driving force for coalition formation — reflecting optimum currency area considerations whereby idiosyncratic shocks are the main reason for a country not wanting to join a monetary union. This is reflected in existing papers on international policy coordination involving both a union and outsiders such as Buiter et al. (1995), Canzoneri (1982) and Canzoneri and Henderson (1991). Their distinction of insiders and outsiders stems explicitly or implicitly from asymmetries in the underlying economies. Martin (1995) is closest to our analysis of free-riding incentives that restrict the coalition size. In a model with three countries he shows that economic convergence of a high-inflation country to a low-inflation union may lead to the build-up of these free-riding incentives. Since he restricts himself to a Phillips curve as representation of an individual economy and combines the issue of free-riding with convergence it is difficult to disentangle the relative contribution of these features. Indeed in a symmetric set-up in his model all countries would join the union. In contrast, we show that not all countries automatically join the coalition even in the symmetric case. We argue that it is not asymmetries but the type of externalities (i.e., strategic complements rather than substitutes) which is the reason for the existence of free-riding incentives.

Another strand of literature has linked the economic gains from joining EMU to the purchase of reputation from the (German) central bank (see, for example, Alesina and Grilli, 1993, and Martin, 1995). However, reducing the EMU discussion to reputational considerations has one problem: if the 'toughest' country is to be a member of the coalition, another incentive apart from reputation is

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