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The Impact of US Policy Uncertainty on the Monetary Effectiveness in the Euro Area

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Abstract

This paper examines the role of U.S. economic policy uncertainty on the effectiveness of monetary policy in the Euro area. Using a structural Interacted Vector Autoregressive (IVAR) model conditional on high and low levels of U.S. economic policy uncertainty, we find that uncertainty regarding policy changes in the U.S. dampens the effect of monetary policy shocks in the Euro area, with both price and output reacting more significantly to monetary policy shocks when the level of U.S. policy uncertainty is low. We argue that the U.S. government’s actions regarding policy changes in the U.S. is a source of uncertainty for Euro area investors and high levels of policy uncertainty that spill over from the U.S. drive Euro area investors to adopt a wait-and-see approach, leading to a relatively weaker (and sometimes insignificant) response of price and output to monetary tightening in the Euro area. The findings underscore the importance of market integration and coordination of economic policy changes on the effectiveness of monetary policy on the macroeconomy on both sides of the Atlantic. Our results thus, provide evidence in favour of the policy ineffectiveness hypothesis in the Euro area contingent on the economic policy uncertainty of the U.S.

Keywords: Economic Policy Uncertainty, Monetary Policy, Interacted Structural Vector Autoregressive Model

JEL codes: C32, C51, C54, E30, E31, E32, E52
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