



Financial structure and monetary policy transmission in transition countries

Adam Elbourne^a, Jakob de Haan^{b,c,*}

^a *University of Groningen, the Netherlands*

^b *Faculty of Economics, University of Groningen, PO Box 800, 9700 AV Groningen, the Netherlands*

^c *CESifo, Munich, Germany*

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Using the structural vector autoregressive methodology, we present estimates of monetary transmission for the new and future EU member countries in Central and Eastern Europe. Unlike most previous research we include ten transition countries. We examine to what extent monetary transmission in these countries is related to financial structure indicators, using an approach similar to that used by Cecchetti [Cecchetti, Stephen G., 1999. Legal structure, financial structure, and the monetary policy transmission mechanism. Federal Reserve Bank of New York Economic Policy Review 5 (2), 9–28] to investigate this issue for eleven old EU member countries. Unlike Cecchetti's results for the old EU member countries, we find little evidence of any link between financial structure indicators and monetary policy for these ten accession countries. *Journal of Comparative Economics* 34 (1) (2006) 1–23. University of Groningen, the Netherlands; Faculty of Economics, University of Groningen, PO Box 800, 9700 AV Groningen, the Netherlands; CESifo, Munich, Germany.

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* Corresponding author. Fax: 31 50 3633720.

E-mail address: jakob.de.haan@rug.nl (J. de Haan).

1. Introduction

On 1 May 2004, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, and Slovenia joined the European Union (EU). Bulgaria and Romania are likely to become members of the EU in 2007. After joining, new members must abide by the same EU laws and rules that apply to the old members, i.e., the *acquis communautaire*. These regulations include the single currency project; hence, the new EU member countries are expected to adopt the euro at some future date. Some countries have already indicated that they want to join the euro area as quickly as possible.

Various observers warn that enlargement of the euro area may hamper the policies of the European Central Bank (ECB). According to Guiso et al. (1999), at least three conditions must be met for a common monetary policy to succeed without causing frictions among the members of the monetary union. First, members must agree on the ultimate goals of the common monetary policy; this issue was settled by the Maastricht Treaty and the ensuing ratification process, leading to the adoption of price stability as the primary objective for the ECB. Second, a common monetary policy will be easier to implement if the business cycles of the member countries are aligned and if inflation rates are similar, if not the same, as de Haan et al. (2005) argue. If some countries, or even sizeable regions, in the monetary union do not have reasonably synchronized business cycles or inflation rates, determining the appropriate monetary policy stance is difficult. Clearly, countries in the euro area have different inflation rates and output gaps at times, although some authors argue that monetary and economic integration will lead to more business cycle synchronization.¹ Third, the monetary policy transmission mechanism should operate in a similar fashion across the member countries of the monetary union. Differences in the transmission mechanism could make the appropriate size and timing of monetary policy decisions difficult to assess. Moreover, if the burden of adjustment is not shared equally across countries, sizable distributional effects may create political tensions.²

Many authors argue that monetary policy transmission differs substantially across countries in the monetary union in Europe, which may be related to differences in financial structure. Cecchetti (1999) argues that monetary transmission mechanisms vary systematically across eleven (old) EU member countries that are different in the size, concentration, and health of the banking system and that exhibit differences in the availability of primary capital market financing. Estimates of the impact of interest rate changes on output and inflation differ, in the way predicted by the state of the countries' financial systems for these EU member countries, according to Cecchetti's findings.³ The future enlargement of the monetary union will increase the heterogeneity of financial structures in the euro area so that the ECB's monetary policy decisions are likely to have a different impact across the countries in the currency union. Ganev et al. (2002) review the emerging literature on monetary transmission in the accession countries. Our

¹ Frankel and Rose (1998) and Artis and Zhang (1999) make this argument but Inklaar and de Haan (2001) contest the findings of Artis and Zhang.

² However, Adão et al. (2003) argue that economies having different degrees of monetary transmission need not follow different monetary policy rules. Monetary shocks have larger effects, the larger is the extent of the frictions. However, the impact of other shocks is also affected by the extent of the frictions. In Adão et al. (2003), optimal monetary policy is the same in response to common shocks, irrespective of the strength of the transmission mechanism.

³ In contrast, summarizing a large project on differences in monetary transmission across euro area countries in its *Monthly Bulletin* of October 2002, the ECB finds no empirical evidence of systematic differences between countries in policy transmission that are robust across different studies and methodologies. Ehrmann et al. (2003) discuss the role of the financial structure in monetary transmission in the euro area.

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