



Has the transmission mechanism of European monetary policy changed in the run-up to EMU?

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Abstract

This paper studies empirically the transmission mechanism of European monetary policy by means of time-varying, heterogeneous coefficient models estimated in a numerical Bayesian fashion. Based on pre-European Monetary Union evidence from Germany, France, Italy, and Spain, we find that (i) the long-run cumulative impact on output of a common, homoskedastic monetary policy shock has decreased in all countries after 1991. These declines are statistically significant and accompanied by some changes in the conduct of monetary policy over the same period. At the same time, we also find that (ii) cross-country differences in the effects of this shock have not decreased over time.

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1. Introduction

Theory (e.g., Lucas, 1976), as well as a growing body of empirical evidence on the U.S. post-war monetary history – e.g., Boivin and Giannoni (2002, 2003), Cogley

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and Sargent (2004), and Primiceri (2004), among others – suggest that the transmission mechanism of monetary policy may change in response to expected or actual changes in the monetary policy regime. The European Monetary Union (EMU) was launched in January 1999, and the euro started to circulate in January 2001 (almost a decade after the adoption of the Maastricht treaty), replacing the exchange rate mechanism that had anchored the European Monetary System (EMS) for more than 20 years. It is thus natural to ask what has happened to the transmission mechanism of European monetary policy in the run-up to the EMU.

At the same time, a fairly large, albeit sometimes contradicting, body of empirical evidence based on pre-EMU data points to the presence of significant differences across countries (or heterogeneity) in the transmission mechanism of monetary policy in Europe – see Guiso et al. (1999) and Angeloni et al. (2003) for recent surveys of this literature. On the one hand, trade and financial integration may increase, and business cycles may become more synchronized, as a result of the currency union (Frankel and Rose, 1998). Hence, these differences might decrease over time if due to these factors. On the other hand, they could also persist for a long time if due to differences in the financial structures rooted in the legal frameworks of individual countries (Cecchetti, 1999). Thus, it would also be useful to have some idea on the time profile of these differences, but there is no hard evidence on whether they are decreasing or persisting over time.

This paper analyses the evolution of the transmission mechanism of European monetary policy by means of time-varying, heterogeneous coefficient models that allow us to test alternative stability and homogeneity assumptions, including particularly the extent to which the impact of monetary policy has changed and cross-country differences have decreased over time. As far as we know, this is the first empirical study of the transmission mechanism of European monetary policy that attempts to do so.

The “experiment” we design incorporates suggestions from the most recent contributions to the empirical literature on the transmission mechanism of European monetary policy and also innovates in one other respect by allowing for regional interdependence in the analysis. First, the specification of the econometric model is the same for all countries considered. Second, following Clements et al. (2001) and Sala (2003), we control for different central banks preferences and procedures as well as intra-Europe exchange rate movements. In addition, by allowing for contemporaneous and lagged interdependence among the open and integrated economies we avoid aggregation biases and provide for a more realistic description of the international transmission mechanism of monetary policy. Overall, these features bring our experiment closer to the “ideal” one described by Guiso et al. (1999).

Obviously, such a framework cannot be estimated without introducing restrictions on the model because of the very large number of parameters involved. We specify the econometric model in terms of a few hyper-parameters and take a Bayesian approach to estimation. In addition, we take a two-stage approach to the analysis. In the first stage, we measure monetary policy by estimating a system of reaction

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