Discussion „Asymmetric trends and European monetary policy in the post-Bretton Woods era“ by Johansson/Ljungberg

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Message of the paper

• Current euro area problems are not caused by non-sustainable fiscal policies in the periphery.
  - Core euro era countries violated the Maastricht fiscal criteria frequently.
  - Some periphery countries with better fiscal performance.

• Current euro problems are caused by the sub-optimal monetary policy in a non-optimal common currency era.
  - According to Taylor rule, policy was too loose in the periphery and too restrictive in the core leading to asymmetric developments (housing bubbles and trade imbalances).
  - Fiscal problems are mainly a result of the bursting of the bubble and financial crisis.
Transmission of monetary policy in the EMU

• “Traditional” view: pass-through of short term money market rates to long rates and bank rates:
  - Incomplete in Euro area countries and important in a bank dominated financial system (Kwapil/Scharler, JIMF, 2010).
  - Strong differences between euro area countries due to lacking integration of the commercial banking sector (Soerensen/Werner, ECB WP 580, 2006).

• “Modern” View (risk taking, lending channel): Integration of financial market intermediation into monetary economics leads to a of the effects of money market interest rate changes on the capital of financial market intermediaries an their lending (Adrian/Shin, Fed NY staff Report no. 398, 2010).
  - Heterogeneity of (shadow) banking sector in the Euro era leads to different effects of short rates changes.
Only monetary policy?

• Mundell-Flemming framework with sticky prices:
  - Long run neutrality of monetary policy and exchange rate adjustments?
  - Real adjustment, in particular wages and labor markets, is needed in some periphery countries.

• Money and government finance: the strongly differing contribution of money creation to government finance in euro area countries before the monetary union witnessed by extremely differing inflation experiences since 1950.

• Unprecedented low interest rates for soft currency countries from 2000 to 2008.
Figure 2.2  Development of cost of living indices in six countries, 1950–2000

Sources: See Figure 2.1.
Fliehkkräfte
Econometric issues

- ECB-Taylor rule estimates are certainly biased:
  - No interest rate smoothing with quarterly data
  - Only backward looking
  - Real time data problem
  - Inconsistent use of target inflation rate in equation (2):

\[
i_t = r + \pi_t + \beta_1 y_t + \beta_2 (\pi_t - \pi_t^*) + \varepsilon_t \quad \text{(original)}
\]
\[
i_t = (r - \beta_2 \pi_t^*) + \beta_1 y_t + (1 + \beta_2) \pi_t + \varepsilon_t \quad \text{(fixed \ \pi^*)}
\]
\[
i_t = r + \pi_t^e + \beta_1 y_t + \beta_2 (\pi_t^e - \pi_t^*) + \varepsilon_t \quad \text{(forward looking)}
\]