MONETARY AFFAIRS IN THE TRANSATLANTIC RELATIONSHIP

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SOME REFLECTIONS

- **What has the euro changed in the EU that affects the relationship?**
- **Have the linkages changed?**
- **How has policy learning developed**

WHAT HAS CHANGED ON THE EUROPEAN SIDE?

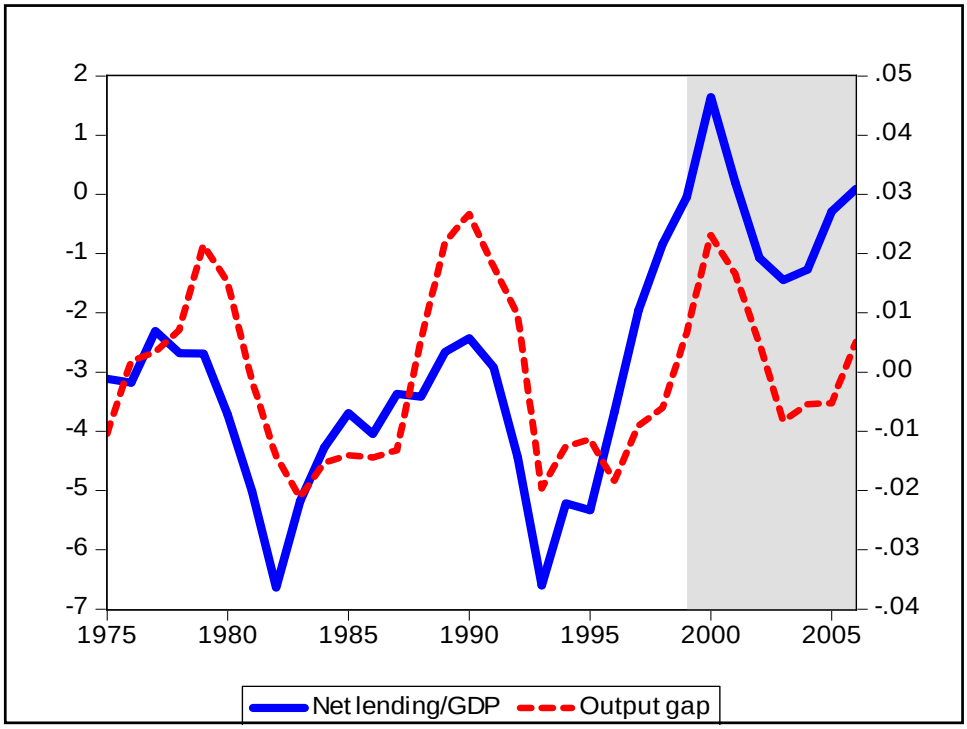
- **Balance between fiscal and monetary policy**
- **Monetary policy**
- **The behaviour of the macro-economy**
- **Convergence**
- **Is it what was expected?**

BALANCE BETWEEN FISCAL AND MONETARY POLICY

- **Fiscal consolidation despite complaints about SGP**

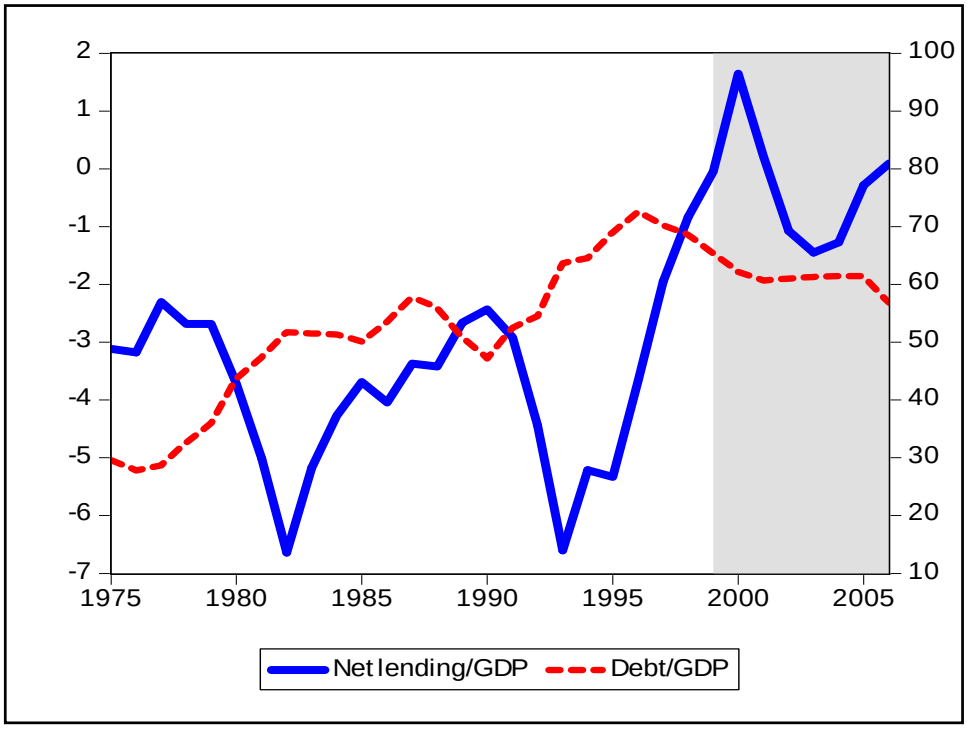
(all data are from OECD 12 euro area countries less Luxembourg, medians – causation not implied – non-euro countries performance similar)

David Mayes and Matti Viren Asymmetry and aggregation in the Euro Area, Palgrave-Macmillan, 2010

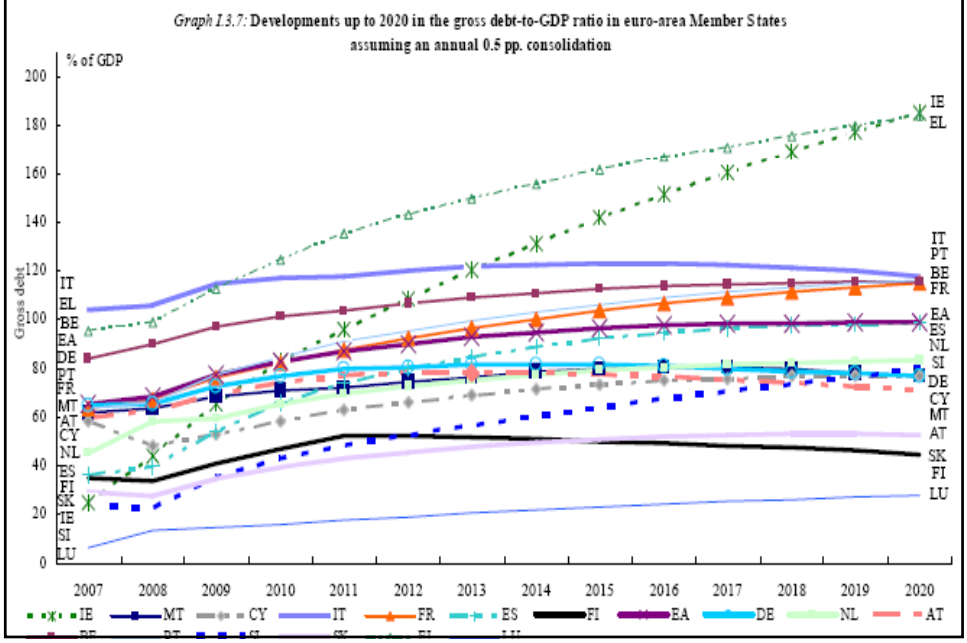


BALANCE BETWEEN FISCAL AND MONETARY POLICY

- **Fiscal consolidation despite complaints about SGP**
- **Debt performance turned round – but totally reversed by present crisis**

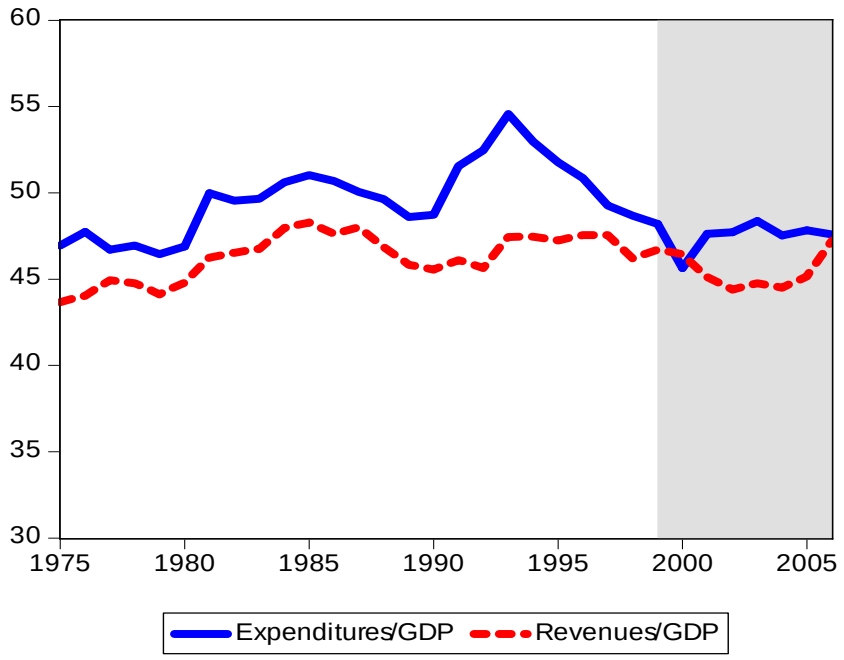


Commission debt projections



BALANCE BETWEEN FISCAL AND MONETARY POLICY

- **Fiscal consolidation despite complaints about SGP**
- **Monetary policy has not had to work so hard but there has been less discretionary fiscal policy**
- **Main adjustment in expenditure tendency to overcut taxes**
- **Also note Lewis and Hughes-Hallett findings that monetary and fiscal policy may seem uncoordinated ex ante but coordinated ex post**



MONETARY POLICY

- **Taylor rule**
  - **Inflation seems unimportant after start of euro area but US perverse coefficient**
    - **Credibility**
  - **Clear asymmetry in EU little response to low inflation not so in US**

MONETARY POLICY

Data	constant	inflation	inflation $\pi<\pi_0$	inflation $\pi\geq\pi_0$	output	lagged r	R2/SEE	DW	Method
1971-2008 CPI, GAP	.390 (6.99)	.067 (6.46)			.184 (9.78)	.910 (85.56)	0.917 1.169	1.81	GLS, FE
1971-2008 CPI, GAP	.516 (6.60)		-.008 (0.11)	.057 (6.01)	.186 (9.71)	.907 (83.37)	0.917 1.166	1.81	GLS, FE
1999-2008 CPI, GAP	1.061 (5.12)	.045 (1.58)			-.057 (1.67)	.810 (24.08)	0.736 0.576	1.57	GLS, FE
EMU 99-08 CPI, GAP	.461 (6.69)	.015 (0.66)			.161 (8.13)	.845 (37.19)	0.906 0.295	1.05	OLS, FE
NEMU99-08 CPI, GAP	.513 (4.67)	.127 (3.11)			.236 (7.34)	.786 (19.72)	0.948 0.283	1.45	OLS, FE
US 1971-08 CPI, GAP	0.258 (1.70)	.123 (2.42)			.291 (4.96)	.878 (25.15)	0.922 0.997	1.84	OLS
US 1971-08 CPI, GAP	.210 (1.12)		.182 (1.8)	.129 (2.4)	.291 (4.91)	.879 (25.03)	0.923 0.999	1.84	OLS
US 1999-08 CPI, GAP	1.227 (2.36)	-.109 (0.63)			.638 (3.73)	.703 (8.32)	0.946 0.451	0.97	OLS

MONETARY POLICY

- **Taylor rule**
  - **Corridor reaction functions – deflation reaction even more vigorous than higher inflation**

Linear corridor model – corridor runs between -0.6per cent and 4.5 per cent

$r_t = .814r_{t-1} + .084GAP_t + .242(\pi_t \,|\, \pi_t < -0.6) + .059(\pi_t \,|\, -0.6 \leq \pi_t \leq 4.5) + .096(\pi_t \,|\, \pi_t > 4.5)$

t1 = 35.82, t2 = 3.13, t3 = 1.10, t4 = 2.21, t5 = 5.91.

R2 = 0.942, SEE = 1.0199, DW = 1.85.

Continuous model with the same corridor

$r_t = .814r_{t-1} + .084GAP_t + .058\pi_t + .037\pi_{t*}(1/(1+\exp(-\theta(\pi_t-\pi_L)(\pi_t-\pi_H))$

t1 = 35.76, t2 = 3.13, t3 = 2.22, t4 = 1.86.

R2 = 0.942, SEE = 1.0199, DW = 1.85. πL= -0.006 and πH = 0.045, θ = 16.4.

MONETARY POLICY

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  - **Jim Lee and Patrick Crowley – paper for tomorrow – also show ECB policy too slack compared to a Taylor Rule – but not if coefficients endogenously estimated in a New Keynesian framework.**

MONETARY POLICY

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  - **Corridor reaction functions – deflation even more vigorous than higher inflation**
  - **Jim Lee and Patrick Crowley – paper for tomorrow – also show ECB policy too slack compared to a Taylor Rule – but not if coefficients endogenously estimated in a New Keynesian framework.**
  - **John Lewis and Andrew Hughes-Hallett – paper for tomorrow – ECB also appears to respond to fiscal policy, some supporting of fiscal expansion but penalising increased debt and unsustainable policy**

THE BEHAVIOUR OF THE MACRO-ECONOMY

- **Small macro-model**
  - **IS curve, Phillips curve, Okun curve , Taylor rule**
  - **All relationships change**
  - **Real interest rate more important in IS curve**
  - **Okun curve more clearly nonlinear – little impact of output growth on unemployment when growth high**
  - **Phillips curve more forward-looking – properly determined output gap**

Table 1 IS curve estimates

	1	2	3
World gdp	.429	.401	.498
	(14.20)	(9.11)	(13.21)
Lagged dep.	.697	.765	.541
	(34.70)	(29.49)	(16.29)
Real ex. rate/100	.259	.913	.761
	(2.05)	(3.98)	(3.97)
Real int. rate	-.010	-.009	-.049
	(1.58)	(0.80)	(2.46)
R^2	0.800	0.825	0.805
SEE	0.008	0.009	0.006
DW	2.207	2.055	2.407
Data	Gap	Gap	Gap
Period	1987-2006	1987-1998	1999-2006

Table 2 Estimates of an Okun curve

	1	2	3	4
Δlog(pop)	.042	.079	.044	.007
	(0.76)	(0.77)	(0.70)	(0.12)
g				
g|g<0	-.192	-.153	-.221	-.232
	(2.27)	(1.74)	(1.38)	(1.38)
g|g>0	-.106	-.121	-.068	-.065
	(9.51)	(7.54)	(6.67)	(6.31)
Error	-.014	-.013	-.019	-.018
correction	(3.37)	(2.22)	(1.76)	(1.65)
R^2	0.159	0.173	0.222	0.263
SEE	0.320	0.260	0.234	0.232
DW	1.406	1.340	1.713	1.711
Data	EU	EU	EU	Euroland
Period	1987-06	1987-98	1999-06	1999-06

CONVERGENCE

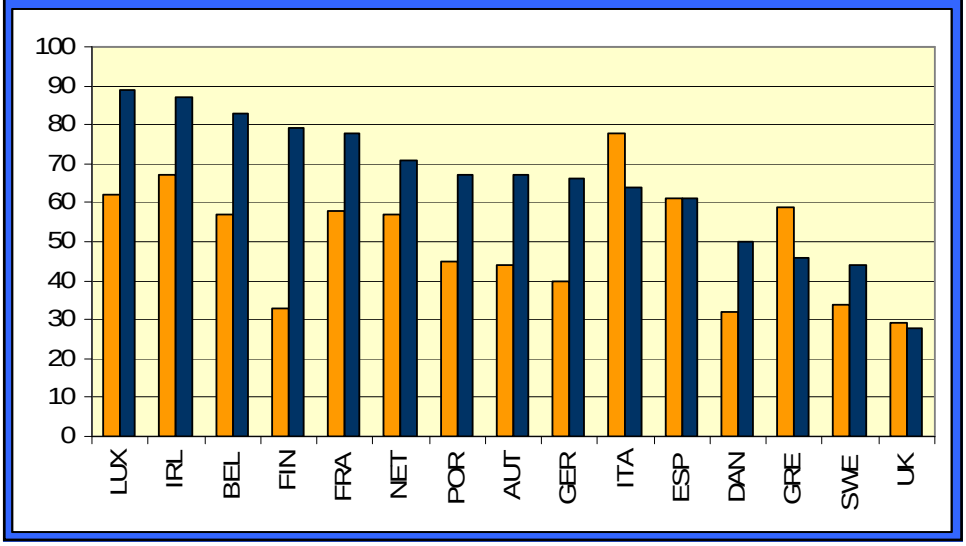
- **Euro area countries have become more similar in a complex manner – need to look beyond the traditional cycle to other frequencies**
  - **Crowley and Mayes**

WAS THIS EXPECTED?

- **No clear expectations but clear changes in opinion**

REFERENDA ON THE EURO

SUPPORT FOR Euro Autumn 97 ***Autumn 2005***



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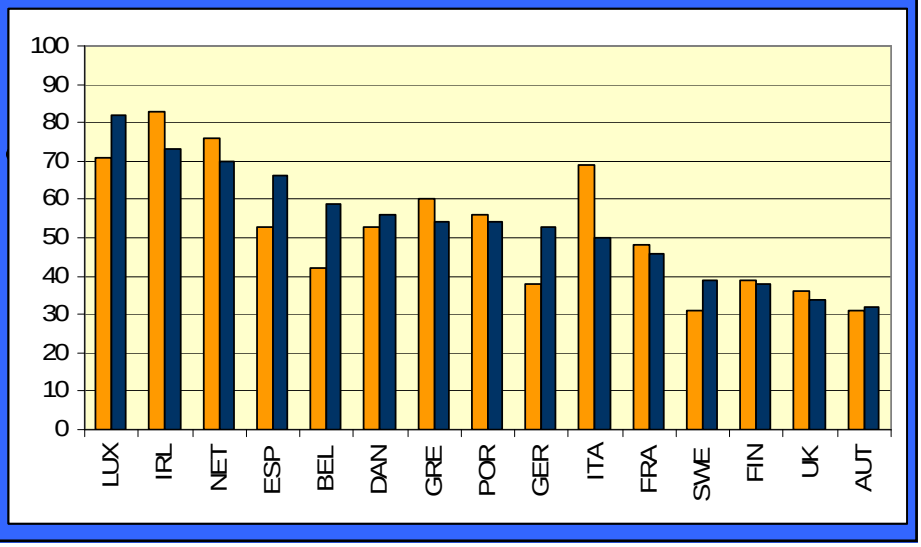

LINKAGES

- **Is there much feedback from EU?**
- **The John Taylor hypothesis**

LINKAGES

- **Feedback from the EU**
  - **Ehrmann – much stronger impact from unexpected monetary policy in US than the reverse – but the impact does exist – US impact falling**
- **The John Taylor hypothesis**
  - **EU policy unduly influenced by US policy**
  - **Is this part of the exchange rate argument? – if do not to some extent follow US rates**

POLICY LEARNING

- **Conscious learning from Fed and Fed banks early on – mistake on voting (Board majority vs speaking)**
- **Clear differences developing or convergence?**
  - **Did not buy the Greenspan standard**
    - **But lack of focus on financial and housing markets?**
    - **Asset prices (house and stock prices) do play a key role in the euro economy and it is asymmetric – different in upturns from downturns**
    - **Simple augmented Taylor rule**
    - $r_{it} = \beta_0 + \beta_1 g_{it} + \beta_2 \pi_{it} + \beta_3 HP_{it} + \beta_4 SP_{it} + \beta_5 r_{it-1} + \varepsilon_{it}$
    - **Small role for stock prices – not so clear from pre euro period – thus most effect lies outside policy**

POLICY LEARNING

- Clear differences developing or convergence?
  - Did not buy the Greenspan standard
  - Strong emphasis on stability of policy not just prices
    - Is this ex-post justification because of consensus approach?
  - Will the present crisis bring convergence
    - Change in US attitudes
    - Dislike of Anglo-Saxon financial markets – only at political level?
    - A move further from closet inflation targeting?