

On Euro: A Stabilisation Role of Monetary Policy Revisited

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“The Euro’s Contribution to Economic Stability in CESEE”

Panel 1: A Case for Rapid Euro Adoption?

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- Euro at its ten
- Expected benefits and stylized facts
- Shocks and volatilities
- Lessons to be learned

Euro at its ten

- Today's reputation of the ECB and Euro is high
 - ◆ Euro has significantly appreciated since its birth
 - ◆ And has become one of world's reserve currencies
- Member countries probably do not constitute an “optimal currency area”
 - ◆ Yet, the ECB has been able to conduct efficient monetary policy and maintain price stability in the euro area
- Overall economic performance of the euro area has not been better or worse than the rest of the developed world
 - ◆ Similar rate of growth in GDP per person in comparison to the non EMU OECD member countries
- Certain divergence in economic performance has been arising
 - ◆ Current accounts

Expected benefits ...

- Higher GDP growth/level per se
 - ◆ No transaction costs
 - ◆ Increase in intra-union trade
- Import of better monetary policy
 - ◆ Price stability
 - ◆ Lower risk premium and lower interest rates
- Lower macroeconomic volatility: No exchange rate shocks
 - ◆ Prior: Exchange rate is the main cause of economic disturbances
 - ◆ Lower volatility in inflation, consumption and GDP

Stylized facts ...

- With no doubts ECB has been able to maintain price stability

Mongelli and Wyplosz (2008): “The euro at ten: unfulfilled threats and unexpected challenges”, Fifth ECB Central Banking Conference The euro at Ten: Lessons and Challenges.

- It seems, however, that GDP growth has been same as elsewhere and/or before

Caselli (2008): “Discussion of Mongelli and Wyplosz”, Fifth ECB Central Banking Conference The euro at Ten: Lessons and Challenges.

Giannone, Lenza and Reichlin (2008): “Business Cycles in the Euro Area” NBER Working Paper 14529.

Stabilisation role of monetary policy

- Central bank – minimising the social costs via minimising the volatility of inflation and output
 - ◆ Fixing the exchange rate = no exchange rate shocks
 - ▶ *Ceteris paribus* lowers volatility in question
 - ◆ However, exchange rate serves also as absorber of ‘other shocks’
 - ▶ *Ceteris paribus* increases volatility in question
 - ◆ There is the common monetary policy in place
 - ▶ ‘Other shocks’ are symmetric – *ceteris paribus* no impact on volatility in question
 - ▶ ‘Other shocks’ are asymmetric – *ceteris paribus* increases volatility in question
- How to measure?

Measuring volatilities ... methodology

- Identify all the shocks over the history using a well designed country specific DGE model
 - ◆ CNB 'g3' forecasting model
- Simulate the model using the identified shocks and calculate volatility in inflation and consumption under three scenarios:
 - ◆ No euro
 - ◆ Euro: common monetary policy in place (symmetric shocks)
 - ◆ Euro: no policy reaction (asymmetric shocks)

Measuring volatilities ... results

- Inflation
 - ◆ Inflation volatility under Euro is higher than without Euro, irrespective of whether the shocks are symmetric or asymmetric
 - ◆ The absence of exchange rate and policy shocks does not deliver lower volatility under Euro; the absence of the exchange rate adjustment channel brings about higher volatility arising from other shocks
 - ◆ However, the exchange rate volatility depends much on a time period, country, and MP regime
- Consumption growth
 - ◆ Volatility of consumption growth is marginally lower under Euro than without Euro
 - ◆ The absence of exchange rate and policy shocks leads to lower volatility under Euro, despite higher volatility arising from other shocks in the absence of the exchange rate adjustment channel

Measuring volatilities ... data

- Two countries with sound and independent monetary policies before the EMU membership
 - ◆ Germany and Finland
- Control country
 - ◆ Sweden

Countries	Germany (volatility, s.d.)			Finland (volatility, s.d.)		
	1994Q1-1998Q4	1999Q1-2008Q2	Diff. (%)	1994Q1-1998Q4	1999Q1-2008Q2	Diff. (%)
Time						
Inflation (q-o-q)	1.53	1.44	-5.9	1.09*	1.52	+39.4
Consumption (q-o-q)	2.41	2.97	+23.1	1.10	1.81	+64.5
GDP (q-o-q)	2.55	2.25	-11.8	2.39	2.52	+5.4

*1995Q2-1998Q4

Source: IMF database and own calculations

Control country	Sweden (volatility, s.d.)		
	1994Q1-1998Q4	1999Q1-2008Q2	Diff. (%)
Time			
Inflation (q-o-q)	1.49*	1.55	+4.0
Consumption (q-o-q)	2.07	2.28	+10.1
GDP (q-o-q)	2.11	2.07	-1.9

*1995Q2-1998Q4

Source: Sweden Statistics and own calculations

Lessons to be learned

Price stability can be achieved both with and without euro:

1. Change in monetary policy regime can not itself increase GDP growth
 - Lower transaction costs and increase in intra-trade may lead to better performance, but ten years of euro existence do not seem to prove that
2. Monetary regime affects economic adjustment to shocks in a business cycle
 - Exchange rate has been a source of disturbances, but monetary policy can also overcome this through its stabilisation role
 - It certainly holds for the CR, data for period 1998 – '08

Naturally, it is country and time dependent

- ◆ Credible monetary policy and consistency of other policies are necessary conditions
- ◆ Variance of exchange rate shocks may increase over time, e.g. during the recent crisis

Thank you for your attention!

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