

# Has the Monetary Transmission Process in the Euro Area Changed? Evidence Based on VAR Estimates

Axel A. Weber, Rafael Gerke, and Andreas Worms  
Deutsche Bundesbank

Discussion by Marvin Goodfriend  
Carnegie Mellon University

BIS Conference, Luzern, Switzerland  
June 26-27, 2008

# Main Contributions

- Useful survey of potential effects on monetary transmission—creation of Euro, globalization, and financial innovation
- Main empirical findings
  - Statistically significant evidence of structural break in monetary transmission 1996-1999
  - Monetary transmission for 1980-1996 not significantly different from that for 1999-2006

# Interpretation

- The paper concludes: “...our evidence implies that the link between policy actions and outcomes is likely to have become generally more uncertain.”
- That characterization seems unwarranted.
- I interpret the findings in a more positive way.
- I conclude with a few positive thoughts on the relationship among monetary policy, globalization, and financial intermediation.

# The 1980-2006 Sample

- Puzzle: restrictive interest rate shock reduces output in the long run, unable to bring the price level down.
- Interpretation: VAR specified in terms of the levels of real GDP, GDP deflator, indicator of housing wealth, 3-month nominal Euro interest rate, constant term, exog.
- Real GDP, PGDP, housing wealth trend upward.
- Short-term interest rate exhibits break at 1996-1999, averages 8% before and 4% after the break (Appendix).

# The 1980-2006 Sample (2)

- Euro lowered average short rate with lower inflation and expected inflation, and greater liquidity premium.
- Transition also raised level of potential output due to efficiency-gains in the European Union.
- Negative covariance of nominal short rate and output innovations in VAR estimated over 1980-2006 is an artifact of factors related to the transition to the Euro.

# The 1980-2006 Sample (3)

- Strongly persistent variables in VAR produce puzzling “long run” findings.
- Full-sample findings expected if Euro and European Union achieve objectives.

# The Split Sample

- When sample split between before and after Euro, long-run response of output and prices to interest rate shock is as expected.
- Dynamics of monetary transmission statistically indistinguishable in the split sample.
- Is this what one might have expected?
- Perhaps...Deutsche Bundesbank led European monetary policy in the decades before the Euro; and the monetary policy of the European System of Central Banks follows Bundesbank's procedures.

# Split Sample (2)

- Before the Euro, European countries partially imported Bundesbank monetary policy by way of various fixed exchange rate arrangements.
- Average inflation rate in Europe high before run-up to Euro because countries exploited option to devalue their currencies against the D-mark rather than force inflation down to the German inflation rate.



# Monetary Stability, Globalization and Financial Innovation

- 1) Globalization today was made possible by the taming inflation in the United States under Paul Volcker.
  - Inconceivable that Russia, China, India, and other countries would have liberalized if Volcker had not shown that market system in the United States could manage inflation successfully.
  - Germany, Switzerland, and Japan had shown this to be possible earlier, but their success was thought to be cultural and not easily exportable.
  - When US succeeded against high and rising inflation, other countries knew they could too.

# Monetary Stability, Globalization and Financial Innovation (2)

- 2) Globalization and financial innovation increase opportunity for trade, product variety.
- Resiliency, flexibility, and capacity to create value by combining inputs and selling into different markets.
  - Markets positioned to overwhelm monetary policy thought to lack credibility for low inflation, or regulatory policies that create incentives for evasion. Competitive, innovative markets can hardly do otherwise.
  - Threat of market challenge provides discipline for monetary and regulatory policies.
  - Reduces scope for inefficient, unsustainable policies.

# Monetary Stability, Globalization and Financial Innovation (3)

- 3) Recurring episodes of asset market turmoil in US since the 1980s suggest to some the need for greater regulation to contain volatility due to globalization and financial innovation.
- Alternative positive view: the stabilization of inflation has raised the life expectancy of economic expansions in the US.
  - Economic expansions used to die prematurely of “go-stop” monetary policy when central banks insufficiently preemptive of rising inflation were forced time and again to bring expansions to an early end to stabilize inflation.

# Monetary Stability, Globalization and Financial Innovation (4)

- Inflation stabilization improved the performance of asset markets, and greatly enlarged the scope for extreme asset price fluctuations, by preempting rising inflation and lengthening economic expansions.
- Consequently, economic expansions have “lived” long enough to “die” of asset price fluctuations rather than of a loss of credibility for low inflation followed by tight monetary policy.

# Monetary Stability, Globalization and Financial Innovation (5)

- Just as increased life expectancy creates health problems only rarely seen before, so too has the lengthening of business expansions in the US created stabilization problems rarely seen before.
- Markets might be expected to improve the pricing of financial products and assets over time as they gain more experience in an environment with relatively low and stable inflation.
- We should keep this in mind before we conclude that globalization and financial innovation have somehow made financial markets in the US permanently, and intolerably unstable.