Comments on *Challenges for the ECB* by

Dornbusch, Favero and Giavazzi

Andrew K. Rose

U.C. Berkeley, CEPR and NBER

Haas School of Business, University of California, Berkeley, CA USA 94720-1900.

Tel: +1 (510) 642-6609, Fax: +1 (510) 642-4700, E-mail: arose@haas.berkeley.edu.

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Dornbusch, Favero and Giavazzi (hereafter "DFG") are to be congratulated for tackling a potentially important problem. They address some of the key issues that the newly-appointed European Central Bank (ECB) will have to confront immediately upon taking office in 1999. In particular, DFG focus on the question "Does the ECB face a serious problem because of asymmetric effects of monetary policy?"

Potentially this is a topic of vital concern. Consider the scenario of an asymmetric shock hitting a country which has surrendered its monetary sovereignty by joining EMU. Since European labor is immobile and no substantive system of fiscal transfers exists, the costs of this shock are entirely borne by the country. To make things concrete, consider a precipitous decline in the demand for, say, Finnish hi-tech goods. The ECB is pursuing tight monetary policy, either to establish credibility or because of the state of the European business cycle. A fringe nationalist party contests an election on an anti-Europe platform, arguing that the Finnish recession stems from a tight money policy pursued the dark forces of Frankfurt, in blatant disregard of Finland's woes. Indeed, if DFG are right, the recession may stem from the uneven incidence of tight European monetary policy. The party is swept to power on a platform of repatriating power to Helsinki. The worst-case scenario is that Finland drops out of EMU. After all, what goes in can come out; currency arrangements are anything but permanent, as shown by the 1992 departures from the EMS. Of course, joining a common currency is a much more serious commitment than fixing an exchange rate. But even if the Finns retain the Euro, they have any number of protectionist measures open to undermine the single market. Then again, the ECB may kowtow to the Finns, leading to inappropriate loose European monetary conditions.

The best way solution to this problem is to avoid it in the first place. Thus I certainly agree with the authors that developing European-wide support for the ECB and its goal of low inflation is an immediate and important policy objective.

Problems like this are conceivable. But are they likely? I have considerable doubts about the relevance of my secession scenario, and therefore of the likely importance of the issues raised by DFG. My skepticism can be stated in the form of four questions:

1. Has monetary policy really had large asymmetric effects?
2. How relevant is the historical data?
3. How enduring will the issue be? and
4. Will the ECB need to change monetary policy?

1: Is the Evidence of Historical Asymmetries Compelling?

It is by no means clear that monetary policy has had substantially asymmetric effects in Europe. This is not to say that the evidence in favor of uniform effects is any more compelling. A Scottish verdict of "Not Found Guilty" is most appropriate.

As DFG readily admit, there is not much work which can be used to shed light on the issue. Many of the existing models have endogenous exchange rates, and are therefore irrelevant. When exchange rates are exogenous – as in the lower panel of Table 5.1 – the effects of monetary policy seem broadly similar across countries. The new evidence provided by DFG in Table 5.5 shows similar impact effects of monetary policy across countries. And while the effects of monetary shocks are statistically distinguishable after two years, all the action comes from Sweden and the UK. While financial channels point to Italy, Sweden, and UK as being disproportionately affected by monetary policy, the evidence is weak..

In any case, not all countries are equal, at least vis-à-vis the ECB. The evidence presented by DFG under-emphasizes the small countries, who constitute much of EMU. Further, the strongest evidence of asymmetries concerns Sweden and the UK, countries of limited concern to the ECB. After all, for a region to be of concern it must be: 1) in (EMU); 2) asymmetrically affected by monetary policy; 3) and a country. The last point is of consequence; the issue of concern is the *national* effect of monetary policy. Mundell framed the Optimum Currency Area theory in terms of specialized *regions* which are vulnerable to idiosyncratic shocks. Currencies are aligned with countries, not regions; and it is countries that can respond to secessionist pressures. Are countries regions? Usually not. The evidence in the literature (e.g., Obstfeld and Peri in this issue) indicates that many European countries are larger than regions (areas within which labor is mobile). Certainly large countries like Italy and Germany seem to have a number of different regions; even Belgium seems to have different regions. And some regions span countries: Northern Italy may have more in common with Southern Germany than with Southern Italy. Regional effects of monetary policy are less threatening if regions are not aligned with countries.

In any case, how large do asymmetries have to be for them to worrisome? What's the benchmark? Carlino and DeFina (1996) find large regional differences in the response of output to monetary shocks for three of eight American regions. But while academics sometimes ask whether the United States is to be large to be an optimum currency area, there has been no serious talk of splitting the country into different currency zones. In any case, Bayoumi and Eichengreen (1993) find that the congruence of the EC core was roughly comparable to that of US regions, well before EMU and the continuing integration of European markets.[1]

I conclude that we simply don't know if monetary policy has really had strong asymmetric effects in Europe. But even if we did have such evidence, would it be relevant?

2: Is History Bunk?

As DFG are aware, the "Lucas Critique" states that history may be irrelevant in the face of a substantial change in policy. EMU surely counts as the policy regime par excellence. Do we believe that statistical evidence gleaned from a regime of fixed but adjustable exchange rates is valuable for the EMU era? On the one hand, EMU has been widely anticipated and the shift in monetary objectives is clearly specified. On the other hand, nature does not make jumps.

While it is hard to be sure, I am inclined to agree with Henry Ford: the endogeneity of the economy's structure is not an issue of academic (read "trivial") importance. DFG discuss the potentially important effects that EMU will have on integration in financial and labor markets. These changes may be large and fast; then again, they may be small and gradual. Unfortunately, the dearth of comparable experiments does not provide evidence one way or another.

In any case, goods markets may be as profoundly affected by EMU as labor and capital markets. Two countries which surrender their national currencies will surely trade more, as the European Commission has stressed. As trade increases, business cycles change. Reduced trade barriers will lead countries to specialize more in their industries of comparative advantage. If shocks are mostly industry-specific, then business cycles will become more *asynchronized*, making my "secession" scenario more likely. But if intra-industry trade dominates inter-industry trade, or if common (demand) shocks are larger than industry-specific shocks, then increased trade will result in greater business cycle *synchronization*. The impact of EMU on the synchronization of European business cycles is thus uncertain, at least theoretically. But the ambiguity turns out only to be theoretical. Jeffrey Frankel and I have found empirically that reduced trade barriers have been associated with greater trade and increased business cycle synchronization.[2] As EMU leads to more trade and more synchronized European business cycles, the "secession" scenario becomes less likely.

3: A Bubble on the Tide of Empire?

The differences in the monetary transmission mechanism are likely to be mostly transitory. As DFG stress, financial and labor markets structures will adjust; certainly inflation convergence of inflation is already leading to more uniform patterns of long- and short-term finance. While I agree with DFG that the increased competition may take a while to have an effect, the dangers will certainly diminish with the passage of time. The problems that DFG raise are short-term.

This short-run problem will only exist if EMU starts with the joining countries either a) out of phase or b) close to capacity so that inflationary pressures are building. Is there reason to be concerned?

Currently, the business cycles of the "ins" seem to be broadly in synch; Table 1 provides recent evidence. Synchronization is no great surprise. First, it has been the historical regularity. Even the enormous effect of German Unification lead to only a slight asymmetry, as the author's Figure 1 shows. Also, both inflation and expected inflation (as measured by the long-term interest rate) have converged, which is presumably why these criteria are in the Maastricht Treaty. Third, countries which are out of phase are less likely to choose to enter EMU; the UK is the most obvious example.

The remaining question is then: Are the "ins" running too hot? How likely is a non-trivial tightening of monetary policy during the early, fragile part of EMU?

4: Genesis or Exodus?

"In the beginning God created the heavens and the earth. And the earth was formless and empty." (Genesis 1:1-2) Is the ECB in a similar situation, creating European monetary policy from a void? If Europe is over-heating in 1998, then a monetary contraction is all the more likely in the dangerous early years.

But is 1999 really a monetary Genesis? A better analogy may be Exodus: the ECB is leading Europe into the promised land out of the bondage of the Buba.

Clearly the job of the ECB will be much easier if the monetary conditions are reasonable in late 1998. A Buba gift of tight monetary policy going into EMU will mean a longer honeymoon for the ECB.[3] Europeans may yearn for the bad old days if the ECB is forced to raise interest rates quickly. Is the ECB likely to have a trial by fire because the Buba leaves monetary policy too loose?

It is conceivable, but unlikely. The ECB would be forced to tighten monetary policy only if European conditions demand tighter money than is dictated by the German conditions that concern the Buba. But, to reiterate, business cycles seem synchronized across Europe. And the Buba tends to err on the side of tight money in any case. It is thus hard to believe that the ECB will be forced to raise interest rates more than the token amount needed to start the long process of building credibility.

Conclusion

I expect business in Frankfurt to be much the same in 1999 as in 1998. The decisions will be made in a different way in a different building by different people. But a dramatic difference in monetary policy is unlikely. Of course, a smooth monetary transition is to be hoped for, not to be sneered at. The real effects of EMU will emerge with time, and are likely to surprise (and inform) economists.

The short term effects of EMU are just as likely to be political as economic. European politicians have spent their best energies of late making painful sacrifices on the altar of EMU. Millions of Europeans may become quickly disillusioned when a common currency proves not to be the magic bullet that ends a decade of high unemployment and slow growth.

Table 1: OECD Forecasts of Output Gaps

	'97	**'98**
Austria	-1.3	-0.9
Belgium	-2.4	-1.7
Denmark	-0.8	-1.7
Finland	-0.4	0.3
Germany	-1.2	-0.8
France	-2.3	-1.6
Ireland	0.7	1.1
Italy	-2.3	-2.3
Netherlands	0.1	0.3
Portugal	-1.1	-0.8
Spain	-2.3	-1.9
Europe	**-1.6**	**-1.2**

Source: OECD.
All figures are annual percentages.

Endnotes

[1] Bayoumi, Tamim, and Barry Eichengreen, 1993, "Shocking Aspects of European Monetary Unification," in F. Giavazzi and F. Torres, eds., *The Transition to Economic and Monetary Union in Europe*, Cambridge University Press, New York.
[2] *The Endogeneity of the Optimum Currency Area Criteria*, forthcoming in *Economic Journal* 1998.
[3] More accurately, a Buba bequest.