

Strasbourg, December 13th 2019



Welcome to the 3rd edition

of the

ERMEES Macroeconomics Workshop

20 YEARS OF THE EURO: PATHS FOR THE FUTURE?



BETA
Bureau
d'économie
théorique
et appliquée



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Programme Workshop

		Collège Doctoral Européen ¹
Morning	8:30	<i>Registration and Welcome breakfast, Jardin Intérieur – first floor</i>
	9:00	Opening Speech
	9:15	Plenary Session (<i>Amphithéâtre - Ground floor</i>) Antonio Afonso (<i>Lisbon School of Economics and Management, University of Lisbon</i>)
	10:30	<i>Coffee Break, Jardin Intérieur – first floor</i>
	11:00	Parallel session 1a: Monetary Policy I , <i>Amphithéâtre</i> Parallel session 1b: Fiscal Policy I , <i>Petit Auditorium</i> Parallel session 1c : Labour Market , <i>Salle de séminaire</i>
	12:30	<i>Lunch, Jardin Intérieur – first floor</i>
Afternoon	14:00	Plenary Session (<i>Amphithéâtre - Ground floor</i>) Hubert Kempf (<i>Ecole Normale Supérieure, Cachan</i>)
	15:15	Parallel session 2a: Monetary Policy II , <i>Amphithéâtre</i> Parallel session 2b: International Economics , <i>Petit Auditorium</i> Parallel session 2c: Growth and Cycles , <i>Salle de séminaire</i>
	16:45	<i>Coffee Break, Jardin Intérieur – first floor</i>
	17:15	Parallel session 3a: Financial Issues , <i>Amphithéâtre</i> Parallel session 3b: Fiscal Policy II , <i>Petit Auditorium</i>
	18:45	Closing remarks

¹ 46 Boulevard de la Victoire, 67000 Strasbourg, tram station OBSERVATOIRE (lines C, E, F)

ERMEEES Team

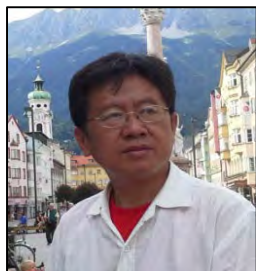


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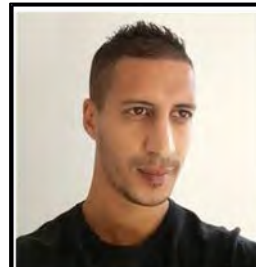


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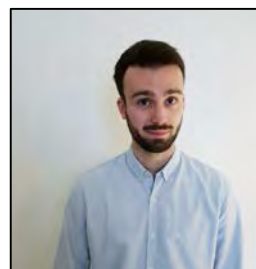


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PhD student

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PhD student



Benoît DICHARRY

PhD student

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PhD student



About us

Created in November 2013, ERMEES (Strasbourg European Macroeconomics Research Team) is the result of an effort bringing together macroeconomists working on European matters within the BETA laboratory (CNRS – UMR 7522). Constituted of experts specialized in European monetary, financial and fiscal issues, ERMEES also intends to contribute to these topics in the public debate.

Keynote Speakers

Antonio AFONSO - *Lisbon School of Economics and Management, University of Lisbon, Portugal*



Prof. Antonio Afonso is Full Professor of Economics in the Department of Economics of ISEG/UL - University of Lisbon. He is currently the President of UECE - Research Unit on Complexity and Economics, President of REM - Research in Economics and Mathematics. Previously, he was Principal Economist at the European Central Bank, Senior Economist at CGD, BNU, and at IGCP, Consultant and Adviser at the Ministry of Finance and also consultant to the IADB, the European Court of Auditors, the OECD, and the IMF.

His research activity focuses on fiscal policy, applied economics, macroeconomics and financial economics

Hubert KEMPF - *Ecole Normale Supérieure, Cachan, France*



Prof. Hubert Kempf is full professor of economics at Ecole Normale Supérieure Paris-Saclay and a foreign part-time professor at the Higher School of Economics (HSE), Moscow. He was previously a Senior Economist at the Monetary and Financial Analysis Department of the Banque de France. He also has been a senior member of the Institut Universitaire de France since October 2011.

His areas of research include macroeconomics, public economics and political economics.

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Detailed Programme

8:30 - 9:00	Registration and Welcome Breakfast
9:00 - 9:15	Opening Speech Moïse SIDIROPOULOS (<i>BETA, University of Strasbourg</i>) Amphithéâtre
9:15 - 10:30	Plenary Session Antonio AFONSO (<i>Lisbon School of Economics and Management, University of Lisbon</i>) "Government Spending Efficiency and Performance" Amphithéâtre
10:30 - 11:00	Coffee Break
11:00 - 12:30	Parallel Sessions <p style="text-align: center;"><u>Session 1a: Monetary policy I</u></p> <p>Chairman: Meixing DAI</p> <p>Maximilian HORST, The Impact of Quantitative Easing on Bank Loan Supply and Monetary Policy Implementation in the Euro Area <u>Reviewer:</u> Aristeia VIDRA</p> <p>Christophe BLOT, Inside the black box of the transmission of monetary policy in the Euro area: explaining heterogeneity <u>Reviewer:</u> Maximilian HORST</p> <p>Aristea VIDRA, Investigating the effect of monetary policy on intermediation margin, output and inflation at zero-lower bound: Evidence from a PVAR analysis in Euro Area <u>Reviewer:</u> Christophe BLOT Amphithéâtre</p> <p style="text-align: center;"><u>Session 1b: Fiscal Policy I</u></p> <p>Chairman: Thierry BETTI</p> <p>Kéa BARET, On Stability and Growth Pact compliance: what is predictable with machine learning? <u>Reviewer:</u> Piotr STANEK</p> <p>Benoît DICHARRY, How to Make EMU More Synchronous? Role of ESI funds in Merging Europe <u>Reviewer:</u> Kéa BARET</p> <p>Piotr STANEK, Twin Deficits Revisited: a role for fiscal institutions? <u>Reviewer:</u> Benoît DICHARRY Petit Auditorium</p> <p style="text-align: center;"><u>Session 1c: Labour Market</u></p> <p>Chairman: Francesco DE PALMA</p> <p>Kristina SARGENT, International Migration: Unemployment Differences and Costs to Move</p>

	<p><u>Reviewer:</u> Povilas LASTAUSKAS</p> <p>Xakousti CHRYSANTHOPOULOU, Monetary and labor interactions in an open economy</p> <p><u>Reviewer:</u> Kristina SARGENT</p> <p>Povilas LASTAUSKAS, Does It Matter <i>When</i> Labor Market Reforms Are Implemented? The Role of the Monetary Policy</p> <p><u>Reviewer:</u> Xakousti CHRYSANTHOPOULOU</p> <p style="text-align: right;">Salle de Séminaire</p>
12:30 - 14:00	Lunch Break
14:00 - 15:15	<p>Plenary Session</p> <p style="text-align: center;">Hubert KEMPF (<i>Ecole Normale Supérieure Paris-Saclay</i>)</p> <p style="text-align: center;">“Monetary Union”</p> <p style="text-align: right;">Amphithéâtre</p>
15:15 - 16:45	<p>Parallel Sessions</p> <p style="text-align: center;"><u>Session 2a: Monetary Policy II</u></p> <p>Chairman: Moïse SIDIROPOULOS</p> <p>Christos MAVRODIMITRAKIS, Debt Stabilisation and Financial Stability in a Monetary Union: Market vs. Authority-based Preventive Solutions</p> <p><u>Reviewer:</u> Salima OUERK</p> <p>Hamza BENNANI, Does a Sentiment Shock Help to Predict Monetary Policy: Evidence from the ECB</p> <p><u>Reviewer:</u> Christos MAVRODIMITRAKIS</p> <p>Salima OUERK, Unconventional monetary policy in the Euro Area: Shadow rates and light effects</p> <p><u>Reviewer:</u> Hamza BENNANI</p> <p style="text-align: right;">Amphithéâtre</p> <p style="text-align: center;"><u>Session 2b: International Economics</u></p> <p>Chairman: Jamel TRABELSI</p> <p>Bas VAN AARLE, Effects of Brexit on the Irish economy: Estimates from a stylized macroeconomic model</p> <p><u>Reviewer:</u> Lukas VOGEL</p> <p>Lukas VOGEL, The role of domestic versus foreign drivers for external (im)balances of euro area countries</p> <p><u>Reviewer:</u> Bas VAN AARLE</p> <p style="text-align: right;">Petit Auditorium</p>

	<p style="text-align: center;"><u>Session 2c: Growth and Cycles</u></p> <p>Chairman: Samuel LIGONNIERE</p> <p>Markus EPP and Anastasia GOLUBEVA, Uncertainty and Hysteresis <u>Reviewer</u>: Fabio MILANI</p> <p>Fabio MILANI, Evolving Beliefs and Animal Spirits in the Euro Area <u>Reviewer</u>: Michaela SCHMOLLER</p> <p>Michaela SCHMOLLER, Stagnant wages, sectoral misallocation and slowing productivity growth <u>Reviewers</u>: Markus EPP and Anastasia GOLUBEVA</p> <p style="text-align: right;">Salle de Séminaire</p>
16:45 - 17:15	Coffee Break
17:15 - 18:15	<p>Parallel Sessions</p> <p style="text-align: center;"><u>Session 3a: Financial Issues</u></p> <p>Chairman: Aristomène VAROUDAKIS</p> <p>Thanassis KAZANAS, An open economy forward looking threshold monetary policy rule model: Evidence from Japan <u>Reviewer</u>: Maxime FAJEAU</p> <p>Maxime FAJEAU, Too much finance or too many (weak) instruments? <u>Reviewer</u>: Samuel LIGONNIERE</p> <p style="text-align: right;">Amphithéâtre</p> <p style="text-align: center;"><u>Session 3b: Fiscal Policy II</u></p> <p>Chairman: Jamel SAADAOU</p> <p>Henri STERDYNIK and CATHERINE MATHIEU, Euro area macroeconomics – where do we stand 20 years later? <u>Reviewer</u>: Jamel SAADAOU</p> <p>Patrick GRUNING, Estimated Fiscal DSGE Model for Latvia <u>Reviewers</u>: Henri STERDYNIK and Catherine MATHIEU</p> <p style="text-align: right;">Petit Auditorium</p>
18:15 - 18:30	<p>Closing Remarks</p> <p style="text-align: center;">Moïse SIDIROPOULOS (<i>BETA, University of Strasbourg</i>)</p>

SESSION 1a: Monetary policy I

Maximilian HORST, The Impact of Quantitative Easing on Bank Loan Supply and Monetary Policy Implementation in the Euro Area.

In March 2015, the Eurosystem started its large-scale asset purchase programme (quantitative easing, QE). The asset purchases induced a rapid and strong increase in excess reserves, implying a structural liquidity surplus in the euro area banking sector. Developing a theoretical model, we show that increasing excess reserves have no or even a contractionary impact on bank loan supply. As the newly created excess reserves are heterogeneously distributed across euro area countries, the impact of QE on bank loan supply may differ across countries. Moreover, we derive implications for monetary policy implementation when the banking sector operates under a structural liquidity surplus. Increases in the central bank's main refinancing rate as well as in the minimum reserve ratio and decreases in the central bank's deposit rate develop expansionary effects on loan supply – contrary to the case in which banks face a structural liquidity deficit.

Keywords: monetary policy, quantitative easing (QE), monetary policy implementation, excess liquidity, loan supply, bank lending channel.

Christophe BLOT, Inside the black box of the transmission of monetary policy in the Euro area: explaining heterogeneity

Since 1999, monetary policy decisions are taken by the ECB for all euro area countries, that is for 11 countries at the beginning and now for 19 countries. Yet, it is still widely acknowledged that EMU is an incomplete monetary union, which may influence the transmission of monetary policy across countries. The aim of this paper is to assess whether the transmission of monetary policy in the euro area is characterized by significant asymmetries and to document the sources of heterogeneities. To that end, we first identify monetary policy shocks by estimating the function reaction of the ECB in the spirit of Romer and Romer (2004). Then, we resort to Local projections to assess the impact of identified shocks on the GDP, the inflation rate and several variables capturing the role of the transmission channels. Our results suggest that the impact of monetary policy on GDP would be larger for the Netherlands, Finland and Portugal. The 3-year cumulated impact of monetary policy would be 2.5 higher in Germany compared to France.

Keywords: Monetary policy, Heterogeneity, Interest rate channel, Credit channel, asset price channel

Aristea VIDRA, Investigating the effect of monetary policy on intermediation margin, output and inflation at zero-lower bound: Evidence from a PVAR analysis in Euro Area

Following the recent decision on 7th of March, European Central Bank to maintain the policy interest rates at zero levels or negative, we investigate the behavior of the usual transmission mechanism of monetary policy through the banking sector. Using panel Vector Autoregressive Model, we investigate the impact of an expansionary monetary policy shock to the real economy of eleven member states of Euro Area when the policy rates of ECB remain at zero lower bound or when they turn negative. We document that this monetary stance devitalizes the bank sector through the supply of bank credit. Finally, we conclude that since negative policy rates decrease bank's net worth, the total impact on the real aggregate output can be contractionary instead of stimulating.

SESSION 1b: Fiscal policy

Kéa BARET, Effectiveness of fiscal performance in the EU: Contributions of Propensity Score Matching

The Stability and Growth Pact (SGP) and especially the 3% limit sets on the fiscal balance purpose to coordinate fiscal policies of the European Union member states and ensure debt sustainability. The Macroeconomic Imbalance Procedure (MIP) scoreboard introduced by the European Commission aims to verify the good conduct of public finances. We propose an analysis of the determinants of compliance with the SGP using a Support Vector Machine model from the recent wave of machine learning. More than testing if the MIP scoreboard variables really matter to forecast the risk of unsustainability, we also test a set of macroeconomic, monetary, and financial variables and apply a prior feature selection model which highlights the best predictors. We give some proofs that main primary indicators of the MIP scoreboard are not useful for SGP compliance forecast and we propose new best variables to forecast the European Union supranational fiscal rule compliance.

Keywords: Debt sustainability, Fiscal discipline, Fiscal Rules, Machine Learning, Support Vector Machine

Benoit DICHARRY, How to Make EMU More Synchronous? Role of ESI funds in Merging Europe

This paper focuses on the potential role of the European Structural and Investment (ESI) funds on the business cycle synchronization in the European Union (EU), which is considered according to the Optimum Currency Areas theory as an inevitable condition for the successful implementation of a common monetary policy. We identify two channels – a direct and the indirect one, by which the ESI funds might possibly affect the level of the business cycle synchronization and apply a panel instrumental variables (IV) approach due to possible endogeneity problem. We instrument actual payments from the ESI funds by planned ESI payments (commitments), which are more likely driven by supranational political factors, rather than endogenous business cycle conditions. Using over 3000 bilateral country-pairs, we find that the ESI funds helped to make the EU's member states' business cycles more synchronized during examined period 2000-2016. We further provide more detailed analysis conducted for each ESI fund and specific EU's country-pairs. Our results suggest the enhancing role of both – the European Regional Development Fund (ERDF) and the Cohesion Fund (CF) in the business cycle synchronization between the EU-15 and the Central Eastern European (CEE) countries, but also among the EU-15 countries as well.

Keywords: Business cycle synchronization; European Monetary Union; Supranational fiscal transfers; European Integration; European Cohesion Policy

Piotr STANEK, Twin Deficits Revisited: a role for fiscal institutions?

We revisit the twin deficit relationship for a sample of 193 countries over the period 1980-2016, using a panel fixed effect (within-group) estimator, bias-corrected least-squares dummy variable, system GMM, and common correlated effects pooled estimation procedures. We estimate the impact of fiscal rules on this relationship. In the absence of fiscal rules, the twin deficit hypothesis is confirmed. The size of the estimated coefficient on the budget balance is between 0.68 and 0.79. However, the existence of fiscal rules strongly reduces the effect of budget balances on current account balances (the coefficient is reduced to 0.1). In addition, our analysis also accounts for various types of fiscal rules (budget balance rules, debt rules, expenditure rules, revenue rules, procedural rules).

Keywords: current account, fiscal balance, fiscal rules, panel data, system GMM

SESSION 1c: Labour market

Kristina SARGENT, International Migration: Unemployment Differences and Costs to Move

When making the decision to move to another country for work, people take into consideration the likelihood of obtaining work, the value of that work (often relative to work at home), and the costs they face when moving and living away from home. In order to more fully understand the effects of costs of migration to workers, I build a two country search and matching model with costs of migration for workers. I focus on fixed move costs as well as a flow cost faced anytime a worker is away from his/her country of origin. Since the characteristics of the labor markets between EU countries and the US and Canada differ along separate dimensions, they can be used to illuminate the importance of costs in a worker's migration decision, and the labor market condition effects of that migration. The model tends to over-predict migration rates in both case studies, and implies that costs to workers moving between EU countries are higher than costs for workers moving between the US and Canada. This second result is in contrast with the higher observed migration in the EU, and highlights important general equilibrium effects and the need for better understanding the migration decision.

Xakousti CHRYSANTHOPOULOU, Monetary and labor interactions in an open economy

This paper extends an otherwise standard New Keynesian open economy model to allow for the presence of large (uncoordinated) unions. It is shown that once the presence of large unions is taken into account, i) the degree of wage setting centralization, ii) the open economy parameters and iii) the degree of aggressiveness of the central bank in stabilizing inflation or output, determine the slope of the New Keynesian Phillip curve. The latter has interesting implications for the rational expectations equilibrium and the inflation/output gap volatility trade-offs faced by the monetary authority. In particular, this paper shows that, under a forward interest rate rule, the rational expectations equilibrium is locally unique, when monetary policy follows the standard «Taylor Principle», with an upper bound that is a negative function of the unions' incentive for aggressive wage claims. In addition, we found that, since labor unions are largely concerned with open economy matters, the choice between inflation-accommodating and anti-inflation monetary policy is important, in the face of cost push shocks, when the monetary authority is unable to commit to future policies. In an economy with high degree of central wage bargaining or/and and high degree of monetary policy accommodation, large unions' wage claims are aggressive and optimal policy results in lower output gap volatility (milder recession) and greater inflation volatility. The opposite (higher sacrifice ratio) holds for an economy with high degree of openness and monetary policy anti-inflationarity. Thus, in our framework and through the highly concentrated labor market, the policy trade-offs for the monetary authority are endogenized.

Keywords: *Non atomistic wage setters, monetary policy, open economy, business cycle, terms of trade.*

Povilas LASTAUSKAS, Does It Matter When Labor Market Reforms Are Implemented? The Role of the Monetary Policy

Do labor market reforms initiated in periods of loose monetary policy yield different outcomes from those that were introduced in periods when monetary tightening prevailed? Since economic theory usually pays attention to the steady state change and ignores business cycle interactions of structural reforms, we connect local projection methodology with the Mallow's Cp averaging criterion to arrive at an inference that does not require knowledge of the exact functional form, is robust to mis-specification, admits nonlinearities, and cross-sectional dependence and addresses uncertainty regarding interactions between labor reforms and macroeconomy. We also develop a test to check the importance of monetary policy for any horizon and the entire impulse response function, taking the multiple testing problem into account. We document that replacement rates deliver substantially different outcomes on real GDP, inflation and real effective exchange rate, whereas activation schemes bear different effects on unemployment in low- and high-interest rate environments. There is also evidence of monetary policy trend playing an important role and increasing synchronized monetary and labor market policies across European countries.

Keywords: Labor reforms, nonlinear responses, local projections, Mallow's Cp criterion for model averaging, error factor structure, low and high interest rate environments.

SESSION 2a: Monetary policy II

Christos MAVRODIMITRAKIS, Debt Stabilisation and Financial Stability in a Monetary Union: Market vs. Authority-based Preventive Solutions

Is a debt-concerned monetary authority desirable? This paper deals with the impact of fiscal-monetary policy interactions in a monetary union on country-specific and union-wide debt stabilisation, when the authorities act strategically. The focus is on the impact that monetary policy would have on a debt-concerned fiscal authority through the debt constraint and the corresponding interaction with decentralised fiscal policies. It is shown that the fiscal monetary (overall) policy coordination strategic regime delivers better results from the non-cooperative regime for both the output gap and the outstanding level of debt at the union level. Two further institutional arrangements are investigated and compared. An authority-based preventive procedure, which works through a debt-concerned monetary authority, and a market-based one, which works through financial markets by assuming a risk premium on country-specific nominal interest rates according to the country-specific fiscal stances. The risk premium acts as a form of 'market-based' discipline. Both regimes stand between the decentralised and the centralised setting. The central bank's optimal weight on union-wide debt stabilisation is computed when financial markets provide discipline to the fiscal authorities. It is optimal for the social planner to appoint a debt-concerned central banker, if there is a degree of conservativeness to the monetary authority and if the social planner cares about union-wide debt stabilisation. A higher risk premium parameter enhances the impact of the former on the optimal weight on union-wide debt stabilisation, while it reduces the impact of the latter.

Keywords: Strategic interactions; Fiscal/monetary policies; Debt stabilisation; Central bank's preferences; Monetary union.

Hamza BENNANI, Does a Sentiment Shock Help to Predict Monetary Policy: Evidence from the ECB

This paper aims to assess whether sentiment shock is helpful to predict ECB monetary policy decisions. We use a computational linguistic approach and several dictionaries on ECB's President introductory statement to derive a measure of sentiment. Next, we orthogonalize the sentiment measure on a set of macroeconomic and financial variables to compute sentiment shock. Finally, we test whether sentiment shock is useful to predict ECB monetary policy decisions. We find that sentiment shock is significantly and positively related to future ECB policy decisions even when controlling for future economic conditions and market expectations about monetary policy. Additional extensions show that the predictive power of sentiment shock is robust to (i) the measure chosen to compute sentiment, (ii) alternative expectations about monetary policy and (iii) the macroeconomic forecasts used in the monetary policy Taylor rule. However, we find that the predictive power of sentiment shock is sensitive to the dictionaries used to compute the measure of sentiment.

Keywords: Sentiment; Forecasts; European Central Bank; Monetary Policy; Taylor Rule.

Salima OUERK, Unconventional monetary policy in the Euro Area: Shadow rates and light effects

We assess transmission mechanisms and the macroeconomic impact of the unconventional monetary policy in the euro area. We estimate a FAVAR model and use a shadow rate to measure the stance of the monetary policy. The ECB's unconventional monetary policy (UMP) measures adopted at the zero lower bound (ZLB) have sustained the real economy. For instance, in 2016, without unconventional monetary policy, investment would have been lower by 9%, consumption by 2% and unemployment rate higher by 0.9%. However, the impact of unconventional monetary shocks is weaker and less persistent compared to these emanating from conventional monetary policy. Furthermore, the difference in the transmission of monetary policies between countries of the euro area is more pronounced during the period 2009-2016. The zero lower bound has therefore decreased the efficiency of monetary policy and accentuated the heterogeneity of the euro area.

Keywords: Monetary transmission, unconventional monetary policies, FAVAR, zero lower bound, shadow short rate, heterogeneity

SESSION 2b: International economics

Bas VAN AARLE, Effects of Brexit on the Irish economy: Estimates from a stylized macroeconomic model

This paper analyses the potential impact of Brexit on the Irish economy. To do so, 'hard' and 'soft' Brexit scenarios are simulated in a small-scale macroeconomic model of the Irish economy. The deviations of the scenarios in the short-run and long-run from a 'no-change' scenario are interpreted as the Brexit effects on the Irish economy. It is clear that Brexit will have non-negligible impact on the Irish economy, even if the overall picture does not come near the effects of the episode of the Financial Crisis. Notwithstanding the short run fluctuations, Brexit is unlikely to have a permanent impact on the Irish economy from a macroeconomic perspective, as long as it would not impact significantly on labour force and capital accumulation. We also consider the effects of a 'soft' Brexit that is accompanied by an increase in FDI in Ireland and a scenario where a 'hard' Brexit is accompanied by an adverse global economic and financial shock.

Keywords: Brexit, Irish economy, Macroeconomic Model

Lukas VOGEL, The role of domestic versus foreign drivers for external (im)balances of euro area countries.

Estimated DSGE models tend to ascribe a large and often predominant part of a country's current account (CA) or trade balance (TB) dynamics to domestic drivers ("shocks"). Individual countries are, in this sense, largely responsible themselves for their CA deficits or surpluses, suggesting spillover and foreign determinants to be of secondary importance only. This paper revisits the result from the DSGE literature by taking a more agnostic approach with respect to transmission channels in the model. We estimate and compare multi-region open-economy models of Germany, Italy and Spain as large Euro Area (EA) countries with very distinct CA patterns since the start of EMU in 1999. Our results suggest that domestic drivers remain dominant when theoretical imposed restrictions on shock transmission are relaxed, although the quantitative role of foreign supply ("competitiveness") shocks increases.

Keywords: Agnostic structural disturbances, domestic and external drivers, estimated DSGE models, euro area, external (im)balances.

SESSION 2c: Growth and Cycles

Markus EPP and Anastasia GOLUBEVA, Uncertainty and Hysteresis

This paper proposes a simple channel for microeconomic uncertainty to affect macroeconomic outcomes. We introduce idiosyncratic uncertainty in a sector operating under monopolistic competition. The

equilibrium of this model can be cast into the Ramsey-Cass-Koopmans form. An uncertainty shock is defined to increase the dispersion of tastes or productivities. Idiosyncratic risks emphasize monopolistic power which affects overall production. The effect is further amplified in the presence of demand externalities. The sign of the effect depends on the degree of substitutability of goods and appears in the absence of adjustment costs or irreversibility. Aggregate returns to scale can be reframed as Martingale-fairness of aggregate growth in total factor productivity. The persistence of the growth effect depends on the persistence of the uncertainty shock. When introducing the growth effect into a general equilibrium model the second moment shock can translate into a bust-boom cycle under fairly general conditions. This explains how the rise of uncertainty after disasters or crises can amplify the downturn of the business cycle. We conclude that high persistence in uncertainty would produce hysteresis in growth. A conservative estimate of the welfare cost of an uncertainty shock is shown to be non-negligible by macroeconomic standards.

Keywords: *Idiosyncratic uncertainty; Monopolistic Competition; Volatility and Growth*

Fabio MILANI, Evolving Beliefs and Animal Spirits in the Euro Area

Michaela SCHMOLLER, Stagnant wages, sectoral misallocation and slowing productivity growth

I propose a two-sector endogenous growth model with heterogeneous sectoral productivity and sector-specific, nonlinear hiring costs to analyse the link between sectoral resource allocation, low productivity growth and stagnant real wages. My results suggest that an upward shift in the labor supply, triggered for instance by a labor market reform, as among others implemented in Germany in 2003-2005, is beneficial in the long-run as it raises growth of technology, labor productivity and real wages. I show, however, that in the immediate phase following the labor supply shock, labor productivity and real wages stagnate as employment gains are initially disproportionately allocated to low-productivity sectors, limiting the capacity for technology growth and depressing real wages and productivity. I demonstrate that due to the learning-by-doing growth externality in the high-productivity sector the competitive equilibrium is inefficient as firms fail to internalize the effect of their labor allocation on aggregate growth. Subsidies to high-productivity sector production can alleviate welfare losses along the transition path.

Keywords: *Subdued Wage Growth, Productivity Slowdown, Misallocation, Endogenous Productivity Dynamics, Labor Market Policies*

Session 3a: Financial Issues

Thanassis KAZANAS, An open economy forward looking threshold monetary policy rule model: Evidence from Japan

This paper has suggested an open economy forward looking threshold monetary policy rule model, which allows for asymmetric responses on the central bank interest rate to exchange rates. These responses depend on the business cycle regime of the economy, i.e., expansion and recession. The paper fits the

model into data from Japan, which is an open economy and may concern about exchange rate movements. The results of the paper provide evidence that the Japanese authorities follow the suggested rule. We have found that these authorities respond more strongly to exchange rate movements (i.e, currency depreciations) in the expansion regime of the economy, compared to the recession one. By so doing, they can anchor more efficiently inflation expectations coming, for instance, from imported goods in the expansion regime and they can avoid the economy falling into deeper recession conditions. To appraise the importance of the suggested monetary policy rule model in conducting monetary policy, the paper has calibrated as small scale New Keynesian DSGE model allowing for open economy features.

Keywords: *Nonlinear Taylor rules, monetary policy, open economy, inflation targets, generalized method of moments, threshold value, switching regime, New Keynesian.*

Maxime FAJEAU, Too much finance or too many (weak) instruments?

In a recent paper published in The Journal of Economic Growth, Arcand, Berkes, and Panizza (2015) produce evidence that financial sector starts having a negative effect on output growth when credit to the private sector reaches beyond 100% of GDP. This comment works to replicate and reanalyze their conclusions. It conducts several diagnostics and robustness checks on the various empirical approaches. Building on an extensive data-gathering, it shows that data cuts critically influence the outcome. Moreover, given the pervasiveness of weak instruments, and the general dependence of the conclusion on a high instrument count, it is hard to rule out reverse or third variable causation. Finally, the near-multicollinearity of the financial proxies and few outliers further questions the existence of a threshold beyond which financial depth tends to adversely affect growth. Therefore, this comment, by reducing the confidence that one can have in the “too much finance” conclusion, serves as a reminder that the finance-growth nexus is more complex and intricate than this simple relationship would suggest. It definitely calls for further research to improve our understanding of the links between finance and growth.

Keywords: *Finance, Growth, Non-linearities, Replication study*

Session 3b: Fiscal Policy II

Henri STERDYNIAK and Catherine MATHIEU, Euro area macroeconomics – where do we stand 20 years later?

For almost 20 years, euro area countries have been sharing a single currency. The drawbacks of the euro area framework were highlighted by the widening of imbalances prior to the 2007 financial crisis, and

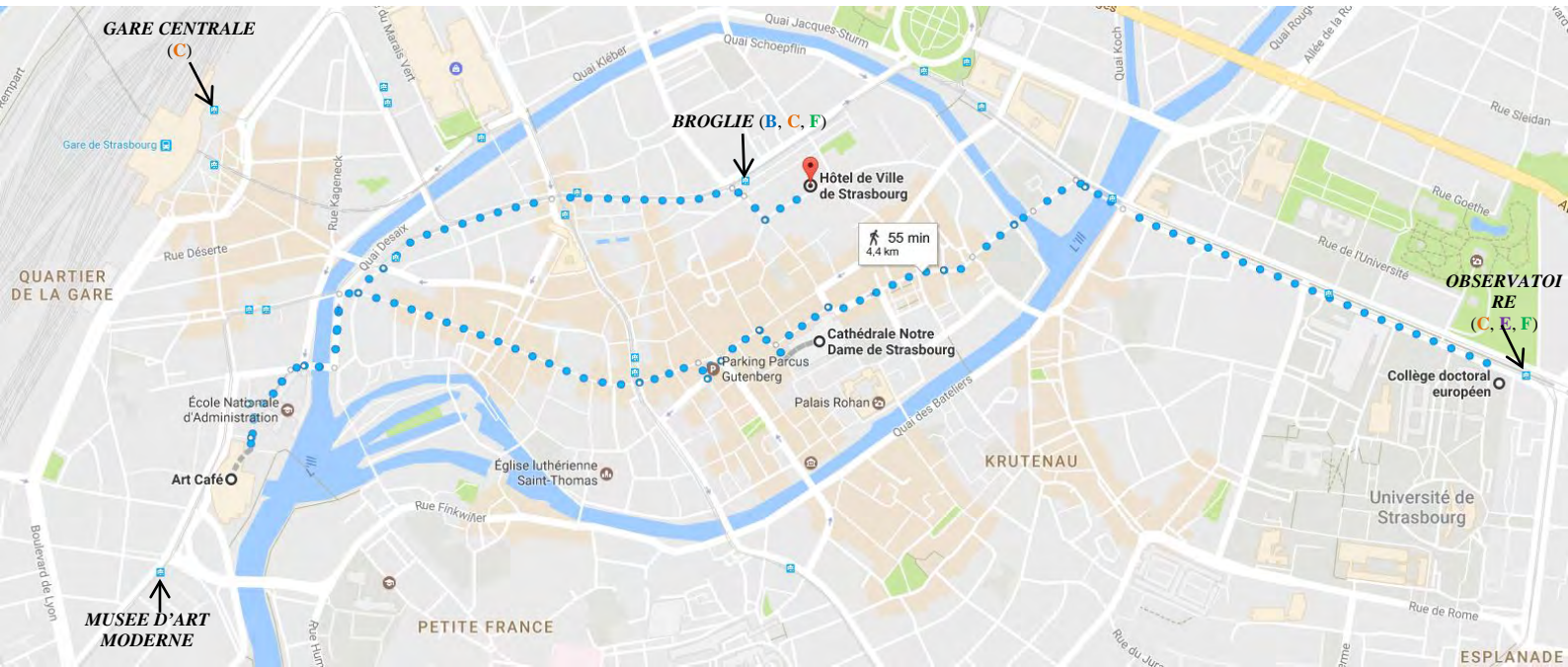
thereafter by the huge impact of the financial crisis, the public debt crisis in Southern European countries, and the Great Recession. Prior to and after the crisis, EU institutions and Member States (MS) have not been able to implement either a common economic strategy or satisfactory economic policy coordination. This led neither to a bursting of the euro area, nor to a substantial change in its functioning. Euro area institutions were adapted, through the European Stability Mechanism, the Fiscal Treaty, the “First semester”, the European Central Bank’s support to MS, and the banking union. These adaptations were painful. In mid-2018, the economic situation had clearly improved at the euro area level. However, the following question remains unsolved: can the functioning of the euro area be improved, accounting for divergent situations, interests and views in MS? The paper recalls proposals from EU institutions and from MS. We present and discuss a number of proposals made by economists to improve the euro area policy framework: relying on financial markets to control domestic economic policies, introducing a euro area budget and a minister of finance, moving towards a federal EU with increased democracy, and last, improving economic policy coordination.

Keywords: Fiscal policy, policy coordination, EMU governance

Patrick GRUNING, Estimated Fiscal DSGE Model for Latvia

We extend Latvijas Banka’s dynamic stochastic general equilibrium (DSGE) model for policy simulations and forecasting purposes with an extensive fiscal sector. The new fiscal sector elements comprise public investment, public consumption, directed asymmetric transfers to both optimizing Ricardian and restricted hand-to-mouth households, cyclical unemployment benefits, and fiscal rules for each fiscal instrument. The model features import content in public consumption and investment, and foreign ownership of domestic public debt. We estimate the model and provide a comprehensive analysis on the macroeconomic effects of the new model elements in the fiscal sector.

Practical Information



Conference place (27th and 28th):

Collège Doctoral Européen (CDE), 46 Boulevard de la Victoire, 67000 Strasbourg

(Tram Station OBSERVATOIRE (lines **C, E, F**))

The ERMEES Workshop Organizing Committee is at your disposal during the conference:

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