

Monetary Transmission Research in Europe: Lessons for Ukraine



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CASE & CASE Ukraine & Institute for Reforms
Kyiv, 9 December 2004

CASE & CASE Україна & Інститут Реформ, 9 грудня 2004

Outline

- Steps & channels of monetary transmission
- Institutional arrangements, monetary policy regimes & transmission mechanism
- Empirical approaches
- Selective review of empirical research on European economies
- Ukrainian perspective – what is needed and why?

Monetary transmission: intro

- ❑ **Transmission mechanism of the monetary policy:** the whole process by which monetary authorities' policies affect macroeconomic variables such as economic activity, price developments, etc.
- ❑ Transmission was a subject of intensive research effort in recent years
- ❑ There is now an increasing understanding of broad issues, but no unique and undisputed view of all aspects involved

Steps of monetary transmission

Note: All classifications are only to organise discussion; there are strong interlinkages

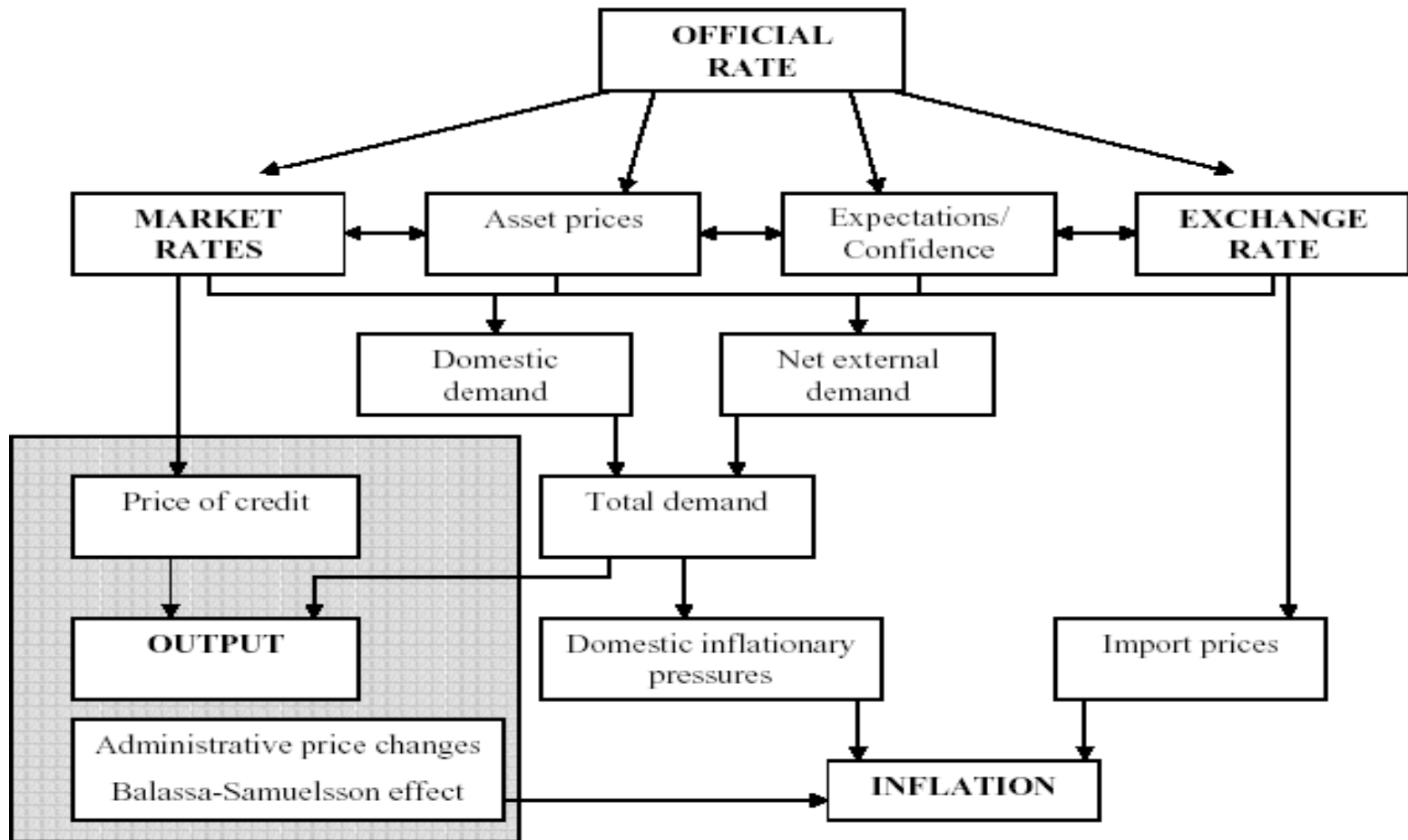
Two **steps** (exposition for a central bank using interest rates as an instrument):

1. from a change in official interest rates to financial and asset markets
2. from financial and asset markets to spending behaviour of firms and households

Channels of monetary transmission

- ❑ **Interest rate channel:** change in official rates → short term market rates → costs of borrowing and lending → saving / investment / consumption decisions
- ❑ **Exchange rate channel:** change in official rates → nominal (and real) exchange rate → 1. prices; 2. relative demand (home vs. foreign goods); 3. wealth effects
- ❑ **Expectations channel:** monetary policy surprises change agents expectations about future (output & prices) → saving / investment / consumption decisions
- ❑ **Credit channel:** banks' propensity to provide capital might change beyond the impact of the price of credit – e.g. after monetary tightening some banks might be forced to adjust quantity of credit and not only its price; similarly for firms (e.g. due to changing value of collateral)

Transmission of monetary policy – a simplified illustration



Source: Ganev et al. (2001)

Institutions & the transmission mechanism

- Monetary regime matters – with fixed exchange rates ability to run monetary policy is effectively given up; in any case external conditions matter a lot for open economies
- Banking system and money market matter – e.g. Ehrmann et al. (2003) lists the following features that would reduce the sensitivity of bank lending to monetary policy changes:
 - the role of state influences in determining credit flows,
 - the prevalence of relationship lending,
 - the size of deposit insurance guarantees,
 - the extent of bank networks

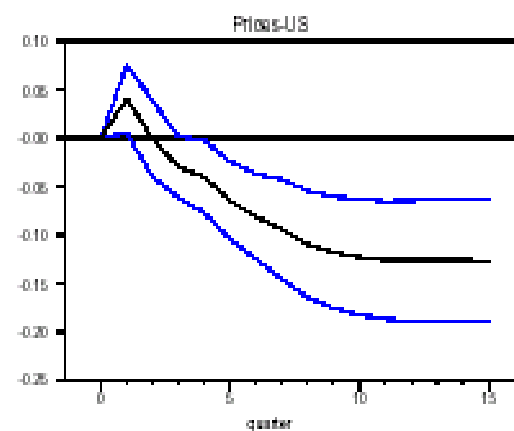
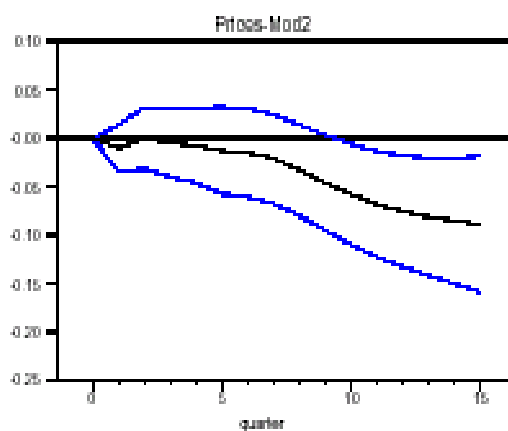
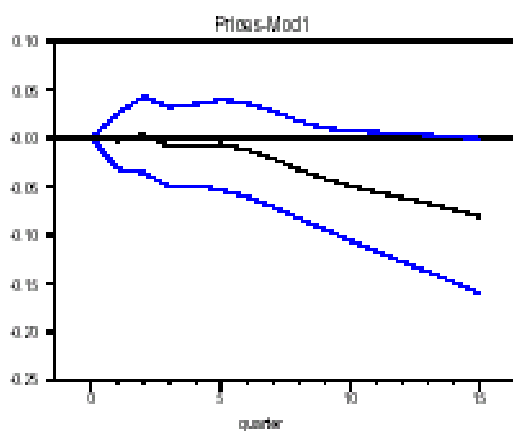
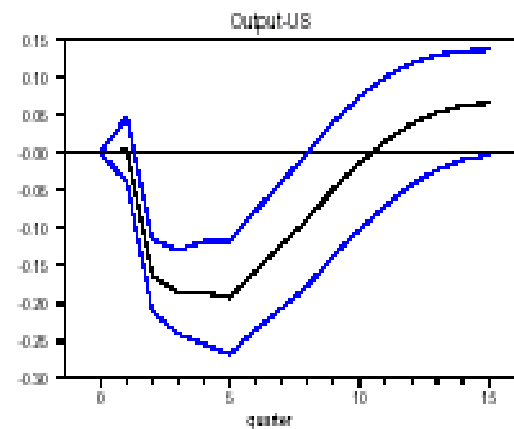
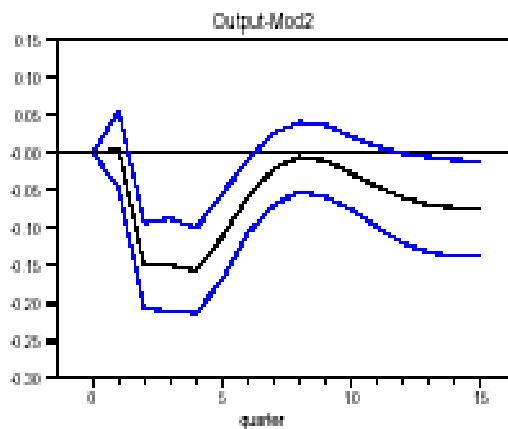
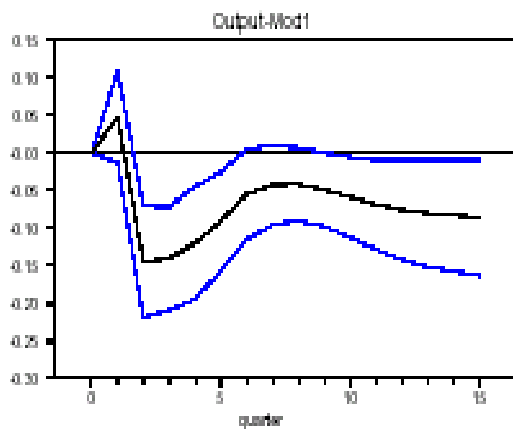
Empirical approaches

- ❑ Less formal narrative, graphical and comparative analyses
- ❑ Studies employing vector autoregressive (VAR) models
- ❑ Studies using structural models – small / large scale
- ❑ Studies based on microeconomic evidence on the behaviour of firms / banks

Euro area – ECB results

- ❑ Eurosystem Monetary Transmission Network – research project (1999-2003) – results in a book and series of ECB WP
- ❑ Interest rate channel can explain nearly all or much of the whole transmission process in Euro-zone countries
- ❑ In some countries bank lending channel also appears important
- ❑ Compared to the US, investment (relative to consumption) appears to be playing a larger role

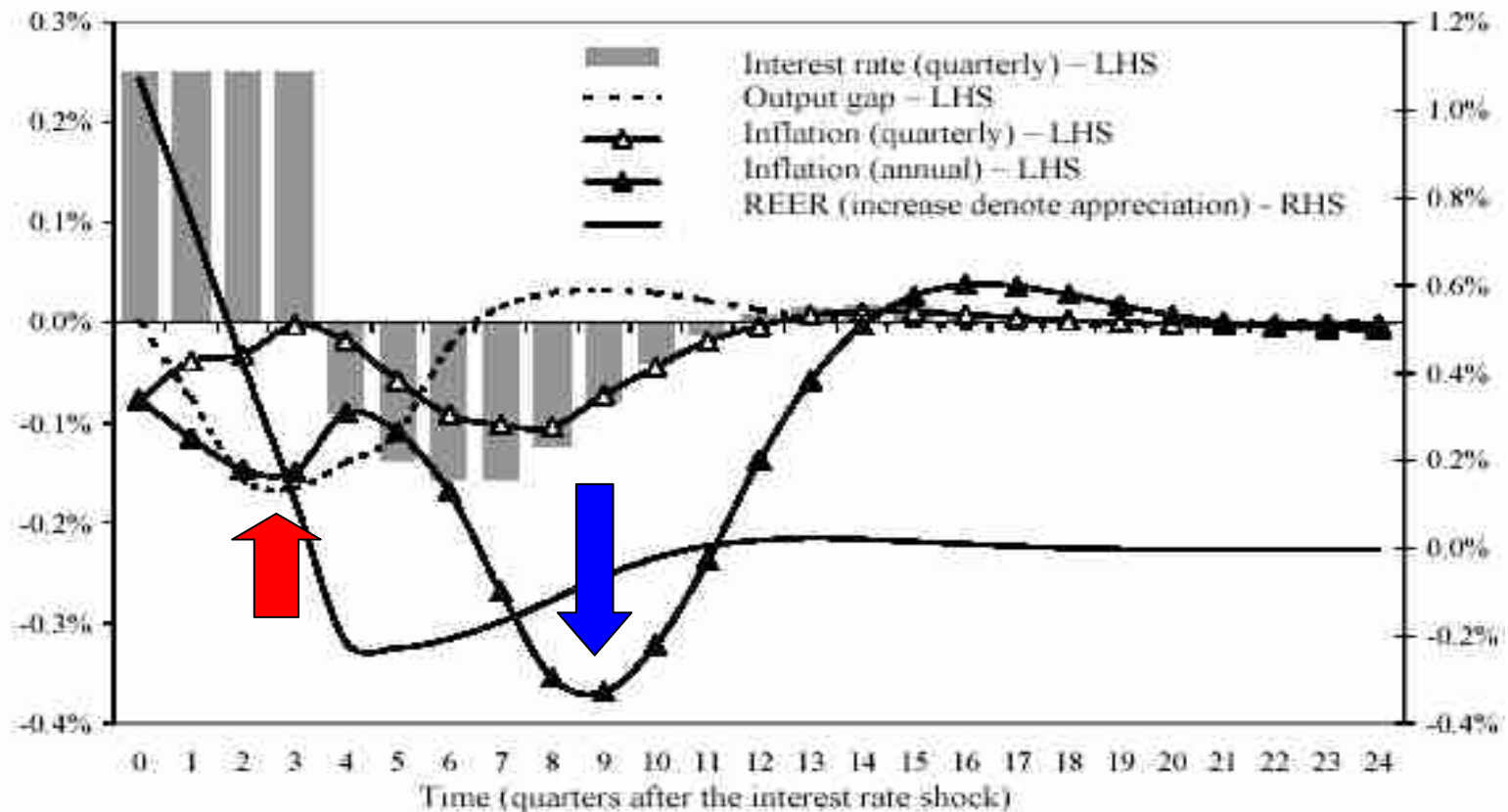
Euro-zone vs. US (VAR results)



Poland – results from structural model

□ Poland – ‘small structural model’ of NBP

Output response strongest in 3rd quarter; inflation 8-9th quarters



Agenda for Ukraine: monetary policy options

- ❑ Increasing financial integration of Ukraine with rest of the world → the whole monetary policy system will likely need some modifications;
- ❑ Recall also recent uncertainty about the exchange rate stability - that is not guaranteed in any way
- ❑ Available options: either an evolution towards a more coherent form of fixed exchange rate system or a move towards greater currency flexibility that would allow monetary policy to serve other objectives, notably price stability

Transmission mechanism – what we need

- Understanding of how monetary policy is (or: can be) transmitted is important for choosing the monetary policy regime
 - it can give an idea as to what an independent monetary policy can possibly achieve (and thus – whether it is worth adopting it)
- Detailed understanding of transmission mechanism is key for monetary authorities' ability to run a policy oriented towards price stability, such as DIT
- Also, transmission needs to be:
 - In place (effective, with not too long lags)
 - More-less stable