Do euro area countries respond asymmetrically to the common monetary policy?

by Matteo Barigozzi, Antonio M. Conti and Matteo Luciani
Temi di discussione
(Working papers)

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Number 923 - July 2013
The purpose of the Temi di discussione series is to promote the circulation of working papers prepared within the Bank of Italy or presented in Bank seminars by outside economists with the aim of stimulating comments and suggestions.

The views expressed in the articles are those of the authors and do not involve the responsibility of the Bank.


Editorial Assistants: Roberto Marano, Nicoletta Olivanti.

ISSN 1594-7939 (print)
ISSN 2281-3950 (online)

Printed by the Printing and Publishing Division of the Bank of Italy
DO EURO AREA COUNTRIES RESPOND ASYMMETRICALLY TO THE COMMON MONETARY POLICY? *

by Matteo Barigozzi†, Antonio M. Conti‡ and Matteo Luciani♦

Abstract

We investigate the possible existence of asymmetries among euro area countries’ reactions to the European Central Bank monetary policy. Our analysis is based on a Structural Dynamic Factor model estimated on a large panel of euro area quarterly variables. Although the introduction of the euro has changed the monetary transmission mechanism in the individual countries towards a more homogeneous response, we nevertheless find that differences remain between Northern and Southern Europe in terms of prices and unemployment. These results are the consequence of country specific structures, not of European Central Bank policies.

JEL Classification: C32, E32, E52.
Keywords: monetary policy transmission, asymmetric effects, European Monetary Union, Structural Dynamic Factor model.

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1 Introduction

Before the introduction of the common currency, every Euro Area (EA) member state’s central bank had a different attitude towards the objectives of containing inflation and boosting economic growth (Clarida et al., 1998; Mihov, 2001). After 1999 the European Central Bank (ECB) took over national central banks and imposed a common monetary policy. Nowadays, all EA countries are subject to this single policy, but are still characterized by different economic structures, legislations, fiscal policies, and levels of public debt. Such a diversified environment makes the ECB decision process particularly challenging as member states’ reaction to its policies might be different from country to country.

It is then natural to ask if there is any asymmetry in how single EA countries respond to the common monetary policy decided by the ECB. This is an important question both from the ECB and from member states’ perspective. Indeed, while the ECB has to take into account possible asymmetries in order to avoid instabilities within the EA, member states have to consider their reaction to monetary policy before setting appropriate national policies.

The monetary transmission mechanism in the EA has been already investigated in the literature, both at the aggregate level (Monticelli and Tristani, 1999; Peersman and Smets, 2003; Cecioni and Neri, 2011) and among countries (Mojon and Peersman, 2003; Peersman, 2004) by means of Structural VAR (SVAR) models. In spite of some exceptions (Clements et al., 2001; Ciccarelli and Rebuggi, 2006; Rafiq and Mallick, 2008), a substantial consensus is reached by these studies on excluding asymmetric effects of monetary policy across member states.

In this paper, we use a different approach. We study how single EA countries respond to ECB decisions by estimating a Structural Dynamic Factor model on a large panel of EA quarterly time series spanning the period from 1983 to 2007. We find that, although the introduction of the euro has changed the monetary transmission mechanism in the individual countries towards a more homogeneous response, EA countries react asymmetrically to the common monetary policy in terms of prices and unemployment, while no difference appears in terms of output. We conclude that these differences are the consequence of country specific structures rather than of ECB policies, and hence they should be addressed by means of national fiscal policies, regulation, and structural reforms.

Since the seminal contributions of Giannone et al. (2005), Bernanke et al. (2005), Stock and Watson (2005), and Forni et al. (2009), a factor approach has been used as an alternative to SVAR for macroeconomic analysis. One major advantage of factor models is to allow for dealing with very large panels of data without suffering from the curse of dimensionality.
Moreover, due to strong co-movements among macroeconomic time series, factor models often provide a realistic representation of the data by assuming the existence of few common shocks as the main source of business cycle fluctuations. In the present context, this implies the possibility of disentangling EA-wide from country specific shocks: a desirable feature for analyzing ECB monetary policy, which, by definition, is common to all member states.

Recent literature employed factor models to analyze EA economies although, in general, with a different focus with respect to the present study. Sala (2003) studies the transmission of common monetary policy shocks across European countries but by estimating his model only on pre–euro data. Eickmeier and Breitung (2006) and Eickmeier (2009) conclude that heterogeneity across EA countries is mainly a result of idiosyncratic shocks. Favero et al. (2005) find homogeneous effects of monetary policy shocks on output gaps and inflation rates, while McCallum and Smets (2009) find heterogeneous responses in terms of real wage. Finally, Boivin et al. (2009) show that the common currency has contributed in shaping a greater homogeneity of the monetary policy transmission mechanism across countries.

Among these papers, the study most similar to ours is Boivin et al. (2009). However, while they are mainly interested in financial variables (bond yields, monetary aggregates, and exchange rates), our main focus is on variables of economic activity (GDP and its components, prices, and unemployment). Additionally, the empirical procedure of our study differs from Boivin et al. (2009) in the choice of treatment of structural breaks and identification of monetary policy shocks. Hence, this paper contributes to the procedure used to estimate a structural dynamic factor model and to identify the impact of common monetary shocks on the economic activity of EA member states, and it also adds new evidence on possible cross-country asymmetries in the reaction to these shocks.

In the next Section, we outline the econometric methodology used in the empirical analysis. In Section 3, we describe the dataset and the data transformation used, highlighting some stylized facts related to the existence of co-movements in the EA data. In Section 4, we explain the identification strategy employed, while in Section 5 we discuss country specific impulse responses of prices, output, consumption, investment, and unemployment to the common monetary policy shock. Finally, Section 6 concludes. Additional results are in the Supplementary Appendix available online.

2 Structural Dynamic Factor model

We consider here the Structural Dynamic Factor model firstly introduced by Giannone et al. (2005), Stock and Watson (2005), and Forni et al. (2009), which is a development of the model originally proposed by Stock and Watson (2002) and Bai (2003), and it is a particular case of the Generalized Dynamic Factor model by Forni et al. (2000) and Forni and Lippi (2001). Similar models were also proposed by Sargent and Sims (1977), Geweke (1977), Chamberlain and Rothschild (1983), and Bernanke et al. (2005).

We assume that there exist two kind of sources of business cycle fluctuations in the national EA economies: (i) few structural shocks common to all countries and affecting the whole EA (e.g. monetary policy or oil shocks), and (ii) many idiosyncratic shocks (capturing for example country/regional/sectoral specific dynamics) having only marginal effects on the whole Area. Within this framework we consider a shock as common if it has a non-negligible effect over all EA economies, while we consider a shock as idiosyncratic if it affects only some countries or some sectors. This representation is indeed very realistic: think, for example, of a national
shock having only limited, although maybe non-null, effects outside the country where it originated, or of sectoral-specific effects as in constructions or manufacturing.

Each stationary time series \( x_{it}, i = 1, \ldots, n \) and \( t = 1, \ldots, T \), where \( n \) is the number of variables and \( T \) is the sample length, is written as the sum of two mutually orthogonal unobservable components which account for the two sources of fluctuations: (i) the common component \( \chi_{it} \) and (ii) the idiosyncratic component \( \xi_{it} \). The common component \( \chi_{it} \) is a linear combination of \( r \leq n \) common factors \( f_{kt}, k = 1, \ldots, r \), which are in turn driven by \( q \leq r \) common shocks \( u_{jt}, j = 1, \ldots, q \). Formally:

\[
\begin{align*}
    x_{it} &= \chi_{it} + \xi_{it}, \\
    \chi_{it} &= \sum_{k=1}^{r} \lambda_{ik} f_{kt} = \lambda_i' f_t, \\
    A(L)f_t &= H u_t,
\end{align*}
\]

where \( \lambda_i \) is an \( r \)-dimensional vector of factor loadings, \( A(L) \) is an \( r \times r \) matrix lag polynomial, \( H \) is an \( r \times q \) matrix, \( u_t \), with \( u_t \sim iid(0, I) \), is the \( q \)-dimensional vector containing the common shocks which are orthogonal also to the idiosyncratic components at any lead and lag. The idiosyncratic components can be mildly cross sectionally correlated, while, provided that stationarity is ensured, no assumption is made on their serial correlation properties.

As proved by Forni et al. (2009), consistent estimation of (1)-(3), as both \( n \) and \( T \) go to infinity, and assuming both \( q \) and \( r \) are known, can be achieved in three steps. First, the factors \( f_{kt} \) and the corresponding loadings in (2) are estimated by means of principal components. Second, \( A(L) \) in (3) is estimated by running a VAR on the estimated factors. Finally, given the residuals obtained from the VAR estimation, the common shocks are estimated as the \( q \) largest principal components of the residuals, while \( H \) is estimated by projecting the residuals on the estimated shocks.

From (1)-(3) we can write each observed macroeconomic variable as:

\[
x_{it} = \sum_{j=1}^{q} b_{ij}(L) u_{jt} + \xi_{it} = b_i(L) u_t + \xi_{it},
\]

where

\[
b_i(L) = \lambda_i' A^{-1}(L) H,
\]

are the impulse response functions of the common component of the \( i \)-th variable to the \( q \) common shocks. In this paper, we are just interested in the impulse response functions to the common shock representing the ECB monetary policy. Given its pervasive nature, the monetary policy shock is assumed to be one of the \( q \) common shocks \( u_{jt} \) and we denote it as \( u_{jt}^{mp} \). Without loss of generality, we assume the shock of interest to be the first one, so that the vector of common shocks is \( u_t = (u_{t1}^{mp}, u_{t2}, \ldots, u_{tq})' \) and the impulse response functions

\[\text{The literature has often referred to } f_{kt} \text{ as the static factors, while to } u_{jt} \text{ as dynamic factors. For a formal treatment of the model presented in this Section see Forni et al. (2009).}\]

\[\text{The literature refers to this model as the approximate factor model to be distinguished from the exact factor model which is characterized by cross-sectionally-dynamically uncorrelated idiosyncratic component, i.e. } \xi_{it} \sim iid(0, 1).\]

\[\text{Other estimation methods for model (1)-(3) have been proposed in Doz et al. (2011, 2012).}\]
(4) are written as

\[ b_i(L) = b_i^{mp}(L) + \sum_{j=2}^{q} b_{ij}(L), \]

and we focus only on the first term on the right hand side. However, it is well known that, unless additional restrictions are imposed, only the space spanned by the common factors is identified. As a consequence, impulse responses and common shocks in (4) are identified only up to multiplication by a \( q \times q \) rotation matrix \( R \). In the present context, in order to achieve identification, we impose economically meaningful restrictions as those in Forni et al. (2009), Forni and Gambetti (2010a), and Luciani (2012).\(^6\)

Finally, in order to account for estimation uncertainty, we build confidence intervals using a bootstrap algorithm as in Bernanke et al. (2005) and Eichmeier (2009). At each iteration \( d \), we bootstrap the estimated common shocks \( \hat{u}_d \) and we generate new common factors as \( \hat{f}_d = \hat{A}^{-1}(L) \hat{H} \hat{u}_d \), where the * indicates that, as in Kilian (1998), we correct for the distortion induced by the VAR estimation on the common factors. We then estimate the parameters of equation (3) and identify the shocks as described in Section 4, thus obtaining new bootstrapped impulse response functions.\(^7\)

Collecting together all admissible impulse responses (the one on the sample and those on the bootstrap) gives a distribution of impulse responses from which we can get point estimates and confidence bands by computing the median and relevant percentiles.

### 2.1 Structural Dynamic Factor models in the Euro Area

EA economic history is characterized by two different institutional frameworks separated by the fixing of exchange rates in January 1999. These two exchange rate regimes are likely to have determined a structural break in the data around 1999:Q1. For this reason, we assume the existence of a structural break in our data and we take it into account by proceeding as follows:

1. we estimate the Structural Dynamic Factor model on a panel of 237 quarterly series from 1983:Q1 to 2007:Q4 in order to have consistent estimates of the space spanned by the common factors \( \hat{f}_t \) and consequently of the space spanned by the common shocks \( u_t \);

2. we re-estimate the loadings \( \lambda_i \) for the pre-euro sample (1983:Q1-1998:Q4) and for the euro sample (1999:Q1-2007:Q4) separately;

3. we identify the monetary policy shock separately over the two subsamples.\(^8\)

\(^6\)Let \( R \) be a rotation matrix such that \( RR' = I \), and let \( c_i(L) = b_i(L) R \), and \( \epsilon_i = R' u_i \), then the model \( x_{it} = c_i(L) \epsilon_i + \xi_{it} \) is observationally equivalent to model (1)-(3). As in SVARs, structural shocks and impulse response functions are unique up to an orthogonal transformation (i.e. a rotation) and structural analysis in the present context becomes analogous to the standard structural analysis in VARs.

\(^7\)As demonstrated by Bai and Ng (2006), when \( n \gg T \) the estimated factors can be treated as if they are directly observed rather than estimated, and hence inference on impulse responses can be conducted by ignoring the idiosyncratic component.

\(^8\)Since Weber et al. (2011) find that the transmission mechanism of monetary policy was similar before 1996 and after 1999 but different during the transition period 1996-1998, as a robustness check we perform our analysis on the subsample 1983-1996 rather than 1983-1998. Results are identical to the one obtained with our benchmark specification, and are available in the Supplementary Appendix to this paper.
This procedure is justified on the basis of two results. On the one hand, Breitung and Eickmeier (2011) prove that in presence of a structural breaks, factor loadings $\lambda_i$ may be inconsistently estimated. On the other hand, Stock and Watson (2002) demonstrate that the space spanned by the common factors $f_t$ can still be estimated consistently if there is limited time variation in the loadings. The latter is a reasonable assumption in the context of EA, as the introduction of a single currency was indeed a gradual process which started in February 1992 with the Maastricht Treaty, and continued with the launching of the fixed exchange rate regime in January 1999 and the creation of the ECB, as established by the Treaty of Amsterdam effective since May 1999.

Given their relevance for our analysis, we need to formally test these assumptions on the behavior of the common factors and their loadings. In order to do so, we first run a CUSUM Square test on the common factors (Brown et al., 1975) and find no significant structural change (Figure 1). Then, we run the structural break test of Breitung and Eickmeier (2011) on the factor loadings, which indicates structural break on January the 1st 1999 for all the series of interest (Table 1). These results are consistent with Canova et al. (2012) and Breitung and Eickmeier (2011).

2.2 Testing for asymmetries

In order to evaluate the presence of significant differences across impulse responses we should test the null-hypothesis of no differences. Olivei and Tenreyro (2010) propose a procedure to test for differences among impulse responses in VAR models. Their test consists in computing differences among observed impulse responses and then compare them with a distribution of distances obtained from data simulated from two different VARs. Unfortunately, this test is unfeasible in our case. Indeed, while Olivei and Tenreyro (2010) aim at comparing impulse responses of the same variable, but estimated from two different (VAR) models, we are interested in comparing responses of different variables, but estimated from the same (factor) model. Hence, in our case we should be able to simulate data from a factor model in which all impulse responses are equal. Building such a distribution would lead to a degenerate distribution in which all distances among impulse responses are zero, i.e. a useless distribution for making inference.

Therefore, in order to have an approximate measure of asymmetries, we rely on a simple procedure with a clearly intuitive meaning. In particular, for each bootstrap, we compute the difference between the individual country response and the Euro Area response. These gives us a distribution of differences between impulse responses. We consider the difference non significant if zero is contained within the confidence bands. A similar procedure is used also by Fielding and Shields (2011).

3 Model setup

3.1 Data and data treatment

Data include EA aggregates, main macroeconomic variables for single EA member states, and key indicators for the United Kingdom, the United States, and Japan. The database contains 9 aggregate EA variables: GDP, CPI, short and long term rates, monetary aggregates (M1 and M3), unit labor cost, real effective exchange rate, and the dollar/euro exchange rate. These

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9We would like to thank an anonymous referee for suggesting us this testing procedure.
aggregate variables are taken either from Eurostat, or from ECB, and, when necessary, they are backdated by using data from the Area Wide Model Database (Fagan et al., 2001).

We then have 35 variables for Germany, Italy, and the Netherlands, 34 for France and Spain, and 31 for Belgium. Variables included for these countries are: interest rates, monetary aggregates, real effective exchange rate, an index of stock prices, GDP and its expenditure components, unemployment rate, unit labor costs, GDP deflator, producer price index, CPI together with its disaggregated categories, retail sales, and number of cars sold. In addition, we also include CPI, GDP, and interest rates for smaller EA countries (Finland, Greece, Ireland, Luxembourg, and Portugal), and for UK, US, and Japan, as well as the spot oil price.

Summing up, our datasets consists of 237 quarterly time series covering the period 1983Q1–2007Q4. The complete list of variables, sources, and the transformations used is available in the Supplementary Appendix.

A comment is necessary on the way we transform data in order to make them stationary. According to Uhlig (2009), the co-movements found by Boivin et al. (2009) in a similar dataset, are actually the result of the autocorrelation induced in the transformed data. As a consequence, the existence of a factor structure, based on co-movements among series, would be just a by-product of data treatment. In order to cope with this critique, and compared with Boivin et al. (2009), we adopt a different set of transformations. As in Stock and Watson (2005) and Forni and Gambetti (2010c), we take second differences of the log of both prices and monetary aggregates, first differences of interest rates, and, when needed, growth rates are computed on a quarterly basis. We label this kind of transformations as heavy, in contrast with light transformations used by Boivin et al. (2009). In the latter case interest rates are kept in levels, the first difference of log of prices and monetary aggregates is taken, and, most importantly, growth rates are computed on a yearly basis.

With reference to Uhlig (2009) critique, our choice of heavy transformations is justified by Table 2, where we report selected percentiles of the distribution of the absolute value of univariate autocorrelations when considering light vs. heavy transformations. The median autocorrelation from lags 1 to 4 is between 0.36 and 0.15 in the heavy case, while it is between 0.86 and 0.28 in the light case. Similar results hold also for other percentiles.

3.2 Number of common shocks and factors

After transforming data, we rely on specific tests and information criteria for determining the number of common factors r and common shocks q. The latter is estimated by means of the test proposed by Onatski (2009), which suggests $q \in \{4, 5\}$ (Table 3) and the criterion by Hallin and Liška (2007) suggesting $q \in \{2, 3\}$. We choose as our baseline specification $q = 4$, i.e. the average of these results.

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10 The sample starts in 1983 because of two main reasons. First, not all the series in the database, especially at the single European country level, are available before 1983. Second, although EA data at the aggregate level are available since 1970 at a quarterly frequency, by comparing alternative aggregation methods, Bosker (2006) shows that differences in EA artificial data are prominent before 1983 especially for inflation and interest rates, while vanishing thereafter.

11 It is worth to note that, within the literature on money demand in the EA (Papademos and Stark, 2010, and reference therein), it is common practice to treat monetary aggregates as I(2) variables. Furthermore, Beyer (2009) and Dreger and Wolters (2010), among others, show that inflation is an important determinant in describing a stable long run money demand equation for the EA, thus indicating that money growth and inflation are cointegrated, and therefore I(1) variables.

12 It is also worth noting that four common shocks is a parameterization considered plausible in the literature. In particular, in her discussion of Boivin et al. (2009), Reichlin (2009) raises some doubts about their choice.
One possible way of fixing the number of common factors is to choose $r$ such that the variance explained by the factors is equal to the variance explained by the chosen $q$ shocks. This heuristic method suggests 13 factors (see Table 5). An alternative is to resort to the criterion provided by Bai and Ng (2002), and its refinement by Alessi et al. (2010), both suggesting either 9 or 14 factors. We choose as our baseline specification $r = 12$, i.e. the average of what the mentioned criteria suggest.\footnote{Other criteria, not used in this paper, to determine $q$ or $r$ are in Bai and Ng (2007), Amengual and Watson (2007), Onatski (2010), and Kapetanios (2010). Results for the criteria by Bai and Ng (2002), Hallin and Liška (2007), and Alessi et al. (2010), as well as robustness analysis for for $q = \{3, 5\}$ and $r = \{9, 13\}$, are available in the Supplementary Appendix to this paper.}

In Table 4 we show the share of variance accounted for by the estimated common component. When looking at the post-1999 sample, we find that 91% of aggregate GDP and 90% of aggregate CPI fluctuations are imputable to the common component. These values decrease if we look at country specific GDP, CPI, and unemployment rate, but are still considerably high in the majority of the cases, notwithstanding the heterogeneity and large dimension of the dataset at hand. Indeed, the variance of the common component is more than 60% of total GDP fluctuations for all countries but Belgium (59%), Finland (54%), Portugal (45%), Greece (44%), and Ireland (12%), while it is more than 70% of total CPI fluctuations for all countries but Portugal (70%), Finland (60%), and Greece (54%), and more than 50% of total unemployment fluctuations for all countries but Belgium (47%) and Italy (36%). When averaging common variances across all 237 considered variables, we have that the common component accounts for 51% of the total fluctuations.

The existence of cross-country heterogeneity in the co-movements both justifies our approach (co-movements imply a factor structure), and motivates our research question (heterogeneity suggests asymmetric reactions).

## 4 Identification of the monetary policy shock

We identify the monetary policy shock by means of sign restrictions (Faust, 1998; Canova and de Nicolò, 2002; Uhlig, 2005), an identification strategy also used in the context of factor models by Eickmeier (2009) and Forni and Gambetti (2010b,c). Specifically, at each iteration we draw a vector of $q(q - 1)/2$ angles $\omega$ from a uniform distribution on $[0, 2\pi)$, which, by means of Givens transform, are used to construct an orthogonal matrix $R(\omega)$ of dimension $q \times q$. We then compute the associated impulse responses and if they satisfy a prescribed set of sign restrictions (to be specified below) we accept the draw, otherwise we discard it. We stop this procedure once $K$ draws are accepted.

We rely on the following assumptions imposed only on EA variables for the first two lags: after a contractionary monetary policy shock the short term interest rate, the real effective exchange rate, and the dollar/euro exchange rate increase, while GDP, CPI, and M1 decrease. These restrictions, which are theoretically consistent with a typical IS-LM model of an open economy, are commonly accepted in the literature (Peersman, 2005; Farrant and Peersman, 2006). Moreover, the choice of imposing restrictions only on the EA variables makes the identification scheme “agnostic” on the responses of single countries (see also Eickmeier, 2009, for a similar identification scheme).
The choice of an “agnostic” identification scheme leaves the room open to non-conventional reactions (see Section 5). Therefore, we also tried to impose country specific restrictions, but we did not find rotation matrices able to satisfy all the restrictions. This result has an economic interpretation as discussed in Sections 5 and 6. In particular, we are able to satisfy some of, but not all, the country specific restrictions. More specifically, restrictions on GDP are easily satisfied, but for Greece in the 1983-1998 sample, whereas restrictions for prices are satisfied only for Belgium, France, Germany, and the Netherlands. There are very few rotations that satisfy the restrictions for prices in Spain and in Italy, but almost no rotations that satisfy the restrictions jointly for Italy and Spain. For Finland, Greece and Ireland we cannot find restrictions for the pre-euro sample, while for Portugal we cannot find them for the post euro sample. Finally, it is worth noting that unconventional reactions of inflation or prices to the monetary policy shock are also found by Sala (2003) for Italy and Portugal, Eickmeier (2009) for Greece and Portugal, Boivin et al. (2009) for Germany, and Peersman (2004) for Austria and Italy.

In order to compute impulse responses and the related confidence intervals, we use the procedure described in Section 2 with 500 bootstrap draws. To keep computations feasible, for each of the 500 + 1 samples we save $K = 10$ rotation matrices. Then, for each sample we select just one rotation matrix as suggested by Fry and Pagan (2011).\(^\text{14}\) An alternative strategy to identify monetary policy is to adopt a recursive identification scheme, i.e. the Cholesky decomposition as in Boivin et al. (2009) and Forni and Gambetti (2010a). Although recently criticized (Canova and Pina, 2005; Carlstrom et al., 2009; Uhlig, 2009; Castelnuovo, 2011, 2012a), this is the simplest, and perhaps, still, the most diffused identification scheme in SVAR literature (Christiano et al., 1999; Peersman and Smets, 2003; Weber et al., 2011). The main problem of this identification scheme is that it relies on zero short-run restrictions, which are too binding and not necessarily based on economic theory. Differently, by using sign restrictions, we are imposing restrictions often used implicitly in empirical analysis to validate the results, and consistent with macroeconomic models. However, if the shock of interest explains a marginal fraction of the forecast error of the variables of interest, the outcome of the exercise conducted with sign restrictions should also be taken cautiously (for a Monte Carlo experiment, see Paustian, 2007; Castelnuovo, 2012b). For these reasons, in the Supplementary Appendix we show also results obtained with Cholesky identification.

5 Results

In this Section, we present impulse response functions to a monetary policy shock. The shock is normalized so that on impact it raises EA short term rate of 50 basis points. In Figures 2-7, we show the impulse responses of CPI, GDP, together with consumption and investment, and unemployment rate both at the aggregate level, and at the country level. Each Figure contains the impulse responses, together with 68% confidence bands, estimated both on the pre-euro sample (grey solid line, and shaded area), and on the euro-sample (black solid and dashed lines).

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\(^{14}\)Fry and Pagan (2011) point out that for each sample the distribution of the $R(\omega)$ that satisfies the sign restrictions represents model uncertainty. However, when computing impulse responses with confidence bands what matters is sampling uncertainty, not model uncertainty. Hence they suggest selecting for each sample just one rotation, namely the one which produces the impulse response closest to the median response.
Figure 2 shows impulse responses for the aggregate EA variables used in the identification of the monetary policy shock and it should be considered just as validation of our identification strategy. In both samples, output, prices, and the monetary aggregate M1 respond negatively, while the short term rate and exchange rates respond positively. Notice that we estimate a strong effect of monetary policy shocks on the economy (in particular on both GDP and CPI).\(^{15}\) However, our estimates are not far from those usually found by the literature (Monticelli and Tristani, 1999; Sala, 2003; Eickmeier, 2009).\(^{16}\)

When comparing pre-euro with euro sample impulse responses of aggregate CPI and GDP, we find that the introduction of the common currency amplified the response of CPI, while reducing the reaction of GDP. This result is consistent with an increase in prices’ flexibility due to greater competition between EA industries.\(^{17}\)

We then move to the analysis of country specific variables. In Figure 8 we show results of the test on the asymmetries introduced in Section 2.2. In each plot of Figure 8 the grey/black straight line is the median difference between the response of a given country and the response of a benchmark country, while the shaded area/dashed lines is/are the 68% confidence bands estimated on the pre-euro/euro sample. If at horizon \(h\) the zero is contained within the confidence bands, it means that the impulse response of a given country and that of a benchmark country are not statistically different at horizon \(h\). In panels (a) and (b) the benchmark country is the EA, while in panels (c), (d), and (e) the benchmark country is Germany.

The goal is to understand whether there are asymmetries in the transmission mechanism of the common monetary policy to EA countries before and after 1999, and to understand which was the effect, if any, of the common monetary policy on the existing asymmetries. Notice also that, in terms of our research question what matters is the direction (i.e. signs) and the significance of the cross-country differences rather than the magnitudes, which turn out to be implausibly high for some of the countries.

5.1 Cross-country differences before 1999

**Prices.** Four countries out of ten (Finland, Italy, Portugal, and Greece) exhibit a positive reaction (Figure 3). In addition to the four countries just mentioned, also the impulse responses of France, Belgium, and the Netherlands are statistically different from those of the EA (Figure 8.a) thus showing a high degree of pre-euro heterogeneity in prices.

**GDP.** All countries, but Greece, react as predicted by economic theory (Figure 4). The unconventional response of Greece seems to be related with the low percentage of variance of Greek GDP explained by the common component (see Table 4). Indeed, it should be noted that Greece was not part of the European Monetary System, as it only joined it in stage II, i.e. in 1999. When testing for asymmetries (Figure 8.b) we find that also the reactions of

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\(^{15}\)The reason for these large magnitudes in the response of prices comes from the heavy transformations choice. In particular, since we model CPI as an I(2) process, we obtain explosive dynamics due to the need of cumulating twice the estimated IRF.

\(^{16}\)Detailed information on the magnitude of the impulse responses estimated by the literature cited in this paper can be found in the Supplementary Appendix.

\(^{17}\)It may be argued that, since before 1999 there was no common monetary policy, the relevant comparison would be between pre–1999 Bundesbank monetary policy, and post–1999 ECB monetary policy (Sala, 2003). Hence, as a robustness check we estimated our model by imposing in the pre–1999 sample the identifying restrictions on the German short term interest rate. Results are near identical to the one obtained with our benchmark specification, and are available in the Supplementary Appendix to this paper.
Consumption. All countries display the expected negative path (Figure 5). However, when testing for asymmetries (Figure 8.c) some differences emerge since both France and the Netherlands react significantly less than Germany, while Italy and Spain react significantly more.

Investment. All countries react as predicted by economic theory (Figure 6) and all react significantly differently than Germany (Figure 8.d).

Unemployment Rate. Unemployment in Germany, France, the Netherlands, and Belgium follows a similar hump–shaped path, while impulse responses for Spain and Italy are different (Figure 7). However, when testing for asymmetries (Figure 8.e) we find that also France and the Netherlands react in a significantly different way than Germany.

5.2 Cross-country differences after 1999

Prices. We can divide EA countries in three groups (see Figure 3). In the first, we have countries for which we observe the expected negative response to the common monetary policy shock: Germany, France, the Netherlands, and Finland. In the second group, we have countries for which we estimate a mute response (i.e. not significantly different from zero): Ireland, Belgium, Spain, Italy, and Greece. Finally, the third group is composed of a single country for which we estimate a positive response, namely Portugal (see also Sala, 2003; Eickmeier, 2009). If we consider these results with reference to pre-euro impulse responses, the introduction of a common currency appears to have had a positive role in shaping homogeneity across countries CPIs. Table 4 provides an explanation of this switch in terms of explained variances of the common components: the higher this number, the more impulse responses are homogeneous. However, significant asymmetries persist between the EA and Finland, Italy, Portugal and Greece (Figure 8.a), with Finland reacting more than the EA, and Italy, Portugal, and Greece reacting less. The response of the Mediterranean countries seems likely to be the consequence of price rigidities and of lack of competition.

GDP. Impulse responses are quite similar across countries (Figure 4). With respect to the pre-euro sample, the response of Greek GDP has now the expected negative sign. Overall, the introduction of the euro has helped in reducing asymmetries. However, small differences are still present between the EA and the Netherlands, Ireland, and Portugal (Figure 8.b). While Ireland and Portugal GDP fluctuations are mainly idiosyncratic (Table 4), the strong reaction of Dutch GDP seems to be driven by consumption.

Consumption. The Netherlands and Italy display the deepest reaction in consumption with a minimum of roughly -5% and -3% respectively (Figure 5), a result also found by Reichlin (2009) in the case of Italy. The response of Netherlands consumption is likely due to the particular dynamics of the series, which has nothing to do with monetary policy. Indeed, from 1999 to 2003 the year on year consumption growth trended downward as a consequence of firms’ and households’ balance sheets adjustments, weak profits, and lower purchasing power of households. Germany, Belgium and Spain also show a significant contraction in consumption up to -1%, while the response is mute for France. The introduction of the euro has slightly reduced asymmetries for Italy and Spain (Figure 8.c).
**Investment.** The reaction of investment is more homogeneous with the main exception of Germany for which a contraction up to -9% is observed (Figure 6). This result is likely due to the dynamics of the German construction sector, as the housing market was characterized by a post-reunification boom-bust cycle in residential investment (Knetsch, 2010). This anomalous response of Germany implies significant differences with respect to all other countries (Figure 8.d), which, however, have all similar responses.

**Unemployment Rate.** As in the pre-euro sample, all countries but Italy and Spain show similar reactions (Figure 7). However, asymmetries are reduced between Germany and France and the Netherlands (Figure 8.e). More specifically, on the one hand Spanish unemployment rate experiments a stronger boost than other countries, on the other hand, Italian unemployment seems not to respond to a common monetary policy shock. The first finding suggests large elasticity of Spanish labor market to monetary policy shocks likely due to the high share of fixed term contracts in the labor market (see for example Güell and Petrongolo, 2007). In contrast, the mute response of Italian unemployment is the consequence of a rigid labor market which seems not to be related at all to the business cycle as confirmed from the low correlation (-0.07) between changes in unemployment rate and GDP growth.  

6 Discussion and conclusions

In this paper we ask the following question: is there any asymmetry in how single EA countries respond to the common monetary policy decided by the ECB? In order to answer we estimate a Structural Dynamic Factor model on a large panel of EA quarterly time series spanning the period from 1983 to 2007. The dataset incorporates data on the aggregate EA as well as country-specific key economic variables, such as gross domestic product, inflation, unemployment, consumption, investment, and many others.

We find that, although the introduction of the euro has changed the monetary transmission mechanism in the individual countries towards a more homogeneous response, differences still remain between North and South Europe in terms of prices and unemployment. Due to their idiosyncratic nature, these differences can hardly be controlled by means of the common monetary policy; rather they should be addressed by means of national fiscal policies, regulation, and structural reforms. Indeed, while before 1999 CPI responses were highly asymmetric, the introduction of the euro and of the single monetary policy, and the consequent increase in integration and competition within the EA, made prices more flexible thus responding more homogeneously to changes in interest rate. The remaining asymmetries are observed in the Mediterranean countries, which historically have less flexible prices and lack of market competition. Similarly, the asymmetries in labor markets seem to be the result of structural and socio-economic characteristics of single countries. This is the case for example with the rigid labor market structure in Italy, which makes Italian unemployment rate essentially unresponsive to the single monetary policy.

In conclusion, EA countries react asymmetrically to the common monetary policy in terms of prices and unemployment, while no difference appears in terms of output. While the post-1999 reduction in asymmetries is consistent with the aims of the ECB (see Boivin et al., 2009), the remaining differences are beyond the scope of monetary policy, and they should be

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Correlations for other countries are: Belgium -0.27, France -0.36, Germany -0.29, the Netherlands -0.26, and Spain -0.34.
addressed by means of national reforms. As demonstrated by the recent/current public debt crisis, and by the skyrocketing of government bond spreads, these differences pose a threat to the region’s stability: addressing them is fundamental for the future of Europe, and it should be a priority if economic cohesion is to be achieved.
References


# Tables

### Table 1: Testing for Structural Break in the Factor Loadings: Breitung and Eickmeier Test

<table>
<thead>
<tr>
<th></th>
<th>BG</th>
<th>FR</th>
<th>GE</th>
<th>TI</th>
<th>NL</th>
<th>ES</th>
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<th>GR</th>
<th>IE</th>
<th>PT</th>
<th>EA</th>
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<tbody>
<tr>
<td>Consumer Price Index</td>
<td>63.44</td>
<td>71.35</td>
<td>72.50</td>
<td>55.46</td>
<td>60.86</td>
<td>64.32</td>
<td>41.56</td>
<td>37.75</td>
<td>48.56</td>
<td>57.69</td>
<td>80.68</td>
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<tr>
<td>Gross Domestic Product</td>
<td>81.41</td>
<td>74.14</td>
<td>76.29</td>
<td>54.57</td>
<td>58.66</td>
<td>79.83</td>
<td>70.87</td>
<td>30.82</td>
<td>39.30</td>
<td>45.10</td>
<td>88.59</td>
</tr>
<tr>
<td>Consumption</td>
<td>70.35</td>
<td>55.96</td>
<td>65.19</td>
<td>66.52</td>
<td>34.19</td>
<td>56.59</td>
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<tr>
<td>Investment</td>
<td>49.91</td>
<td>66.55</td>
<td>52.65</td>
<td>51.76</td>
<td>48.81</td>
<td>68.91</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>66.52</td>
<td>55.61</td>
<td>34.15</td>
<td>47.61</td>
<td>54.45</td>
<td>48.21</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

This Table shows the LM Statistic for the null of no structural break in the factor loadings on January 1st 1999. This statistic is asymptotically distributed as a $\chi^2$ random variable with \( r \) (number of factors degrees of freedoms). The 10%, 5%, and 1% critical values are 18.5493, 21.0261, and 26.2170 respectively.

### Table 2: The Distribution of Autocorrelations Light vs. Heavy

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Log</th>
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<tbody>
<tr>
<td><strong>light</strong></td>
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<tr>
<td>5</td>
<td>0.65 0.40 0.12 0.03 0.03 0.04 0.02 0.02</td>
</tr>
<tr>
<td>25</td>
<td>0.81 0.57 0.32 0.11 0.13 0.12 0.09 0.07</td>
</tr>
<tr>
<td>50</td>
<td>0.86 0.67 0.47 0.28 0.23 0.22 0.19 0.16</td>
</tr>
<tr>
<td>75</td>
<td>0.90 0.78 0.65 0.51 0.43 0.36 0.32 0.29</td>
</tr>
<tr>
<td>95</td>
<td>0.95 0.87 0.78 0.70 0.64 0.58 0.54 0.51</td>
</tr>
<tr>
<td><strong>heavy</strong></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>0.08 0.02 0.01 0.01 0.01 0.01 0.01 0.01</td>
</tr>
<tr>
<td>25</td>
<td>0.24 0.09 0.06 0.07 0.06 0.04 0.04 0.04</td>
</tr>
<tr>
<td>50</td>
<td>0.36 0.18 0.15 0.15 0.14 0.11 0.10 0.10</td>
</tr>
<tr>
<td>75</td>
<td>0.54 0.32 0.27 0.25 0.23 0.18 0.18 0.16</td>
</tr>
<tr>
<td>95</td>
<td>0.90 0.74 0.59 0.50 0.39 0.35 0.30 0.33</td>
</tr>
</tbody>
</table>

Percentiles of the distribution of univariate autocorrelation functions when computing light transformations as in Boivin et al. (2009) or heavy transformations, i.e., by replacing yearly with quarterly growth rates and taking first differences of interest rates and second differences of the log of prices and monetary aggregates.
### Table 3: Determining the Number of Common Shocks: Onatski Test

<table>
<thead>
<tr>
<th>$q_0$ vs. $q_1$</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>0.029</td>
<td>0.050</td>
<td>0.069</td>
<td>0.088</td>
<td>0.104</td>
<td>0.121</td>
<td>0.135</td>
<td>0.151</td>
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<tr>
<td>1</td>
<td>0.271</td>
<td>0.487</td>
<td>0.626</td>
<td>0.321</td>
<td>0.372</td>
<td>0.421</td>
<td>0.465</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>0.608</td>
<td>0.677</td>
<td>0.262</td>
<td>0.321</td>
<td>0.372</td>
<td>0.421</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>0.390</td>
<td>0.195</td>
<td>0.262</td>
<td>0.321</td>
<td>0.372</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>4</td>
<td>0.108</td>
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<td>0.262</td>
<td>0.321</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>5</td>
<td>0.947</td>
<td>0.923</td>
<td>0.343</td>
<td></td>
<td></td>
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<td>6</td>
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<td>7</td>
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<td></td>
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</tr>
</tbody>
</table>

This table shows $p$-values of the null of $q_0$ common shocks against the alternative of $q_0 < q_1$ common shocks. The Discrete Fourier Transformation of the data is computed for $\omega_j = 2\pi s_j/T$, with $s_j \in [2, \ldots, 20]$, thus to includes waves between 1 and 12 years.

### Table 4: Comovements in the Euro Area

<table>
<thead>
<tr>
<th>Country</th>
<th>Explained Variance</th>
<th>83-98</th>
<th>99-07</th>
<th>83-98</th>
<th>99-07</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>GDP</td>
<td>0.71</td>
<td>0.76</td>
<td>0.69</td>
<td>0.80</td>
</tr>
<tr>
<td>France</td>
<td>CPI</td>
<td>0.74</td>
<td>0.78</td>
<td>0.49</td>
<td>0.82</td>
</tr>
<tr>
<td>Netherlands</td>
<td>UR</td>
<td>0.31</td>
<td>0.73</td>
<td>0.73</td>
<td>0.75</td>
</tr>
<tr>
<td>Belgium</td>
<td>GDP</td>
<td>0.66</td>
<td>0.50</td>
<td>0.55</td>
<td>0.81</td>
</tr>
<tr>
<td>Finland</td>
<td>CPI</td>
<td>0.63</td>
<td>0.54</td>
<td>0.31</td>
<td>0.60</td>
</tr>
<tr>
<td>Italy</td>
<td>GDP</td>
<td>0.42</td>
<td>0.66</td>
<td>0.70</td>
<td>0.82</td>
</tr>
<tr>
<td>Spain</td>
<td>CPI</td>
<td>0.38</td>
<td>0.66</td>
<td>0.62</td>
<td>0.90</td>
</tr>
<tr>
<td>Portugal</td>
<td>GDP</td>
<td>0.67</td>
<td>0.45</td>
<td>0.51</td>
<td>0.70</td>
</tr>
<tr>
<td>Ireland</td>
<td>GDP</td>
<td>0.39</td>
<td>0.12</td>
<td>0.33</td>
<td>0.72</td>
</tr>
<tr>
<td>Greece</td>
<td>GDP</td>
<td>0.20</td>
<td>0.44</td>
<td>0.18</td>
<td>0.54</td>
</tr>
</tbody>
</table>

For each country we report the variance explained by the common component of GDP, CPI, and Unemployment Rate (UR). For each variable the first column refers to the 1983-Q1-1998-Q4 (pre-euro) sample, and the second column to the 1999-Q1-2007-Q4 (euro) sample. Values are given on a scale between 0 (no contribute of the common component) and 1.

### Table 5: Cumulated Explained Variance:

<table>
<thead>
<tr>
<th>Number of Factors</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
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</thead>
<tbody>
<tr>
<td>$q$</td>
<td>0.21</td>
<td>0.34</td>
<td>0.43</td>
<td>0.51</td>
<td>0.58</td>
<td>0.64</td>
<td>0.68</td>
<td>0.73</td>
<td>0.76</td>
<td>0.79</td>
<td>0.82</td>
<td>0.84</td>
<td>0.86</td>
<td>0.88</td>
</tr>
<tr>
<td>$r$</td>
<td>0.09</td>
<td>0.16</td>
<td>0.23</td>
<td>0.27</td>
<td>0.31</td>
<td>0.34</td>
<td>0.37</td>
<td>0.40</td>
<td>0.42</td>
<td>0.45</td>
<td>0.47</td>
<td>0.49</td>
<td>0.51</td>
<td>0.53</td>
</tr>
</tbody>
</table>

The table shows the percentage of overall variance explained by the first $q$ common shocks estimated with the method of dynamic principal components as in Forni et al. (2000), and the first $r$ static factors estimated by static principal components. Variance is measured on a scale between 0 and 1.
Figures

Figure 1: CUSUM SQUARE TEST ON THE STATIC FACTORS

Solid line is the CUSUM Square statistic of (Brown et al., 1975), while the dashed lines are the 90% confidence bands computed using critical values as given in Durbin (1969) and Edgerton and Wells (1994).
Figure 2: Impulse Responses to a Monetary Policy Shock
Euro Area Aggregates


Figure 3: Impulse Responses to a Monetary Policy Shock
Consumer Price Index

**Figure 4: Impulse Responses to a Monetary Policy Shock**

*Gross Domestic Product*

![Graph of GDP impulse responses for various countries](image)


**Figure 5: Impulse Responses to a Monetary Policy Shock**

*Consumption*

![Graph of consumption impulse responses for various countries](image)


**Figure 6: Impulse Responses to a Monetary Policy Shock**

*Investment*

![Graph of investment impulse responses for various countries](image)

Figure 7: **Impulse Responses to a Monetary Policy Shock**

*Unemployment Rate*

Germany  
France  
Netherlands

Belgium  
Italy  
Spain

**Figure 8: Quantifying Asymmetries**

**Distance from benchmark country**

(a) **Consumer Price Index**

(b) **Gross Domestic Product**

(c) **Consumption**

(d) **Investments**

(e) **Unemployment Rate**

In each plot, the grey/black straight line is the median difference between the response of a given country and the response of a benchmark country, while the shaded area/dashed lines is/are the 68% confidence bands estimated on the pre-euro/euro sample. If at horizon $h$ the zero is contained within the confidence bands, it means that the impulse response of a given country and that of a benchmark country are not statistically different at horizon $h$. In panels (a) and (b) the benchmark country is the EA, while in panels (c), (d), and (e) the benchmark country is Germany.

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