Do Political events affect business cycle? The Maastrict treaty, the creation of the ECB and the euro economy.

Canova, Ciccarelli and Ortega.

comments by: Carlos Montoro

Central Reserve Bank of Peru

Second Monetary Policy Research Workshop in Latin America and the Caribbean on Monetary Policy, Uncertainty, and the Business Cycle

November 6-7, 2006

Lima - Peru

1 What the paper does?

Analyze the effects of the Maastricht treaty and the creation of the ECB on the Euro Area business cycles?

Changes in institutional and operational features of markets affect business cycles.

No previous study for OECD countries. (**CONTRIBUTION 1**)

I enjoy the paper: I believe institutions matter.

2 How they address this question?

Panel data VAR

7 European countries (Germany, France, Italy, Spain, Belgium, the Netherlands and Finland)

5 endogenous variables (output, employment, industrial production, consumption, investment)

5 exogenous variables (oil price, Y^*, Y^*, $StockPrices^{us}$,i^{fed})

1980:1-2004:4 (100 observations)

3 Panel data VAR

Simultaneous equation format:

$$Y_t = Z_t \delta_t + E_t \qquad\qquad E_t \sim N(0, \Omega)$$

Structural changes $\longrightarrow$ coefficients change over time!

5250 coefficients to estimate in δ_t

Solution: flexible factor structure **(CONTRIBUTION 2)**

$$\delta_t = \Xi_1 \lambda_t + \Xi_2 \alpha_t + \Xi_3 \rho_t + \Xi_4 \psi_t + u_t$$

(time variant, country, variable specific, exogenous variables).

$$1 + N + G + 1 = 1 + 7 + 5 + 1 = 14$$

Use Bayesian methods

4 Synchronicity

λ_t : time varying measure of synchronicity

λ_t large: endogenous variables co-move

λ_t: shrinks co-movement.

5 Results:

Some evidence of changes in the features of the European business cycles.

1990's: less volatile, more persistent, more co-movements.

But they not seem to line-up with these 2 events.

6 But:

6.1 Are the results robust to Lucas' Critique?

Maastricht treaty$\longrightarrow$ change in the fiscal policy rule

ECB$\longrightarrow$ change in the monetary policy rule

There are neither **fiscal** nor **monetary** policy variables in the data.

Are our results **biased** for this missing variables?

6.2 Data only from the 80's

If including data from the 70´s:

Oil price shocks$\longrightarrow$ synchronized recession -would change results?

6.3 Data (again)

GDP (Y)

Consumption (C)

Investment (I)

Employment (U)

Industrial production (Y^{ind})

C and I are already in Y (they co-move already)

6.4 As effects of institutional changes are slow-$>$ effects are mixed up.

This issue has not been addressed