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No. 223

Credibility of interest rate policies in eight EMS countries: an application of the Markov regime-switching of a bivariate autoregressive model

by *Philip Arestis and Kostas Mouratidis*

This paper uses the Markov regime-switching modelling in a bivariate autoregressive framework to study the credibility of monetary policy in eight member countries of the European Monetary System (EMS) during the period 1979–98. The eight countries are: Austria, Belgium, France, Finland, Italy, the Netherlands, Portugal and Spain; a ninth country, Germany, is used as a benchmark case. The output-gap variability and the inflation variability variables are incorporated in the determination of the preferences of individual member countries of the EMS in the conduct of monetary policy. Our empirical evidence shows that, although all countries in our sample follow a credible monetary policy in relation to price stability, not all of them have the same preferences regarding the trade-off between stabilisation of output-gap variability and inflation variability.

No. 224

Wage moderation policy in Germany

by *Ray Barrell, Bettina Becker and Sylvia Gottschalk*

In this paper we briefly discuss the current condition of the German economy and the proposals from the Government in March 2003 to reform labour markets. These reforms involve various measures to reduce the generosity of benefits and to increase the incentives to work. In order to analyse these reforms we simulate a temporary reduction in German real wage growth and discuss how German output, inflation, and interest rates are affected, under two distinct ECB monetary policy rules. We discuss the possible forward looking reactions of the ECB to these reforms and argue that it would be wise to respond in a fully accommodating way. The sensitivity of the ECB to changes in European key macroeconomic indicators is tested by analysing a scenario involving a reduction in French, Italian and German wages. It appears that single country wage moderation policies increase the country's competitiveness relative to other European countries, and hence helps raise the output effects in that country. We also consider that interest rates are set according to pre-1999 rules, with monetary policy more responsive to German conditions. German output would respond

more quickly to the labour market reforms, but the long-run consequences are the same, so there are no sustained benefits from an independent monetary policy.

No. 225

Should we be surprised by the unreliability of real-time output gap estimates? Density estimates for the Eurozone
by *James Mitchell*

Output gap estimates calculated in real time are known to be often unreliable. Recent work has found that, without the benefit of hindsight, it can prove difficult for policymakers to pin down accurately the current position of the output gap. However, attention has focussed primarily on output gap point estimates alone. This paper considers output gap estimates and their uncertainty more generally. As is well known from the forecasting literature, if the outturn falls within the bounds of what was expected, the fact that point forecasts are inaccurate need not mean that forecasts more generally contain no useful information. In this sense, the unreliability of real-time output gap estimates need be neither surprising nor indeed lead to sub-optimal inference by users of the estimates. Interpreting real-time output gap estimates as forecasts, we explain the importance of providing measures of uncertainty, via interval or density forecasts, around real-time output gap estimates. We consider how this can be achieved. The importance of allowing, in particular, for parameter uncertainty is discussed. We then explain how, *ex post*, the accuracy of these measures of unreliability associated with real-time estimates can be evaluated statistically and a decision then made about their reliability. An application to the Eurozone illustrates the use of these techniques in the context of real-time output gap measurement. Simulated out-of-sample experiments reveal that not only can real-time point estimates of the Eurozone output gap be unreliable, but so can measures of uncertainty associated with them. This provides a serious challenge to both producers and users of output gap estimates.



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