THE IMPLICATIONS FOR POLICY MAKING

We present in this issue some contributions relating to topics of considerable current interest in the field of applied financial economics and policy. In this section we collect the main empirical and theoretical conclusions of these studies stressing their implications for policy making.

1. Should countries joining a monetary union retain fiscal independence or should some form of centralization be implemented? The establishment of a monetary union with a single central bank targeting price stability takes away the exchange rate and the monetary instruments from the national stabilization policy packages. In the case of EMU, the constraints imposed by the Maastricht Treaty and the Stability and Growth Pact (SGP) also limit the use of the other stabilization instrument, i.e. fiscal policy. This is the rationale for some form of fiscal centralization in coping with the business cycle or responding to specific country shocks. Antecedent to this matter of institutional design is the economic question whether national authorities should cooperate in the conduct of fiscal policies. In principle, cooperation need not exclude independence, since it only implies that the presence of spillover effects imposed by the policies of one country onto the other is taken into account, so that a position of higher economic welfare may be reached. Cooperation, therefore, does not require control over fiscal intervention to be taken over by a superior authority. The mistrust in the ability of the national authorities to internalize the reciprocal spillover effects may call for some form of centralization.

The paper by V. De Bonis and P. Della Posta, "On the Coordination of National Fiscal Policies in a Monetary Union", addresses the long debated issue of the need for cooperation among national fiscal authorities in a monetary union within the framework of their relationships with the common monetary authority. The conclusions of the paper are: (i) in the lack of cooperation with the central bank, cooperation among fiscal authorities is not desirable; (ii) if the authorities have different targets, both fiscal leadership and monetary leadership result in a Pareto improvement with respect to

the Nash outcome; however, the central bank is better off acting as a follower rather than as a leader; (iii) harmonization of targets makes policy coordination unnecessary, unless countries are hit by asymmetric shocks: in this case, either cooperation among national fiscal authorities or state-contingency of targets are necessary to obtain an efficient outcome.

2. The work of A. Hatemi-J, "Did the Austrian Financial Market Become more Integrated with the German Market after EU Accession?", empirically investigates whether the Austrian financial market has become more integrated with the German market after the Austrian accession to the EU in 1995. Since the underlying monthly data is non-normal with time varying volatility it utilizes a robust method developed recently by Hatemi-J and Hacker (2005). This method is expected to be more accurate compared to other existing methods in the literature because it is insensitive to the presence of non-normality and heteroscedasticity in the error term. It is found that the Austrian market after the EU membership has not become more integrated with the neighboring country. This result might be explained by the home biased hypothesis. These findings have two financial economic implications. Firstly, the diversification possibilities for the Austrian investors to invest in Germany exist even after the accession to the EU. Secondly, the significant relation between the two markets might indicate that the Austrian market is not informationally efficient with regard to the German financial market. Thus, the opportunity for abnormal returns might exist.

3. During the 1990s, China did undergo a structural transformation of the economy invalidating a traditional tool to manage consumption when segmentation between circulation of cash flows or household money and bank accounts or enterprise money broke down. A policy implication was that the cash flow volume was no longer a good indicator of households' purchasing power with mounting financial assets besides cash. The financial base expansion did provide the monetary authority – the People's Bank of China (PBC) – with a possibility to manage consumption through wealth effects and the interest rate channel in line with Hall (1988). By use of cointegration methods and impulse-response analysis, the paper by P-O. Maneschiöld, "Consumption in Urban China and Monetary Policy", estimates an aggregate consumption function for urban China using monthly data incorporating periods of rapid economic growth, inflation and deflation and a monetary authority relying increasingly on adjustment of nominal interest rates for stabilization purposes.

Data analyses yields a number of interesting results providing important policy insights for stabilization purposes in urban consumption and conduct of monetary policy in China. Even though real income is still the most important explaining variable, past real consumption and disposable real income are less important in explaining present consumption after a structural break in the second half of 1996. Instead, inflation is in relative terms much more important. Results show that the policy variable, the 1-year deposit rate, has a limited impact on urban consumption. Inflation is negatively related to urban consumption without a reverse effect on inflation where the 1-year deposit rate has no effect on either inflation or urban consumption. These results suggest that trying to influence urban consumption by changing the 1-year deposit rate, i.e. the PBC's policy variable, is not likely to be a practical policy option.

4. The paper by A.M.M. Masih and V. Ryan, "An Analysis of the Dynamic Linkages between the Cash Rate and the Government Yield Curve: A Case Study", investigates the dynamic linkages between the cash rate and the government yield curve in Australia, in an attempt to examine whether the short-term rate leads the longer-term rates or the other way around. The transmission of monetary policy is usually assumed to run from the short-term cash rate to the longer-term rates. This is in line with the premise behind the expectations theory which states that the market determines the longer-term rates as an average of the expected level of short-term rates over the relevant time horizon. Understanding the link between longer-term yields and the path of short-term rates, particularly the cash rate, is important for anticipating the response of long-term yields to monetary policy changes and for understanding the interest-rate channel of the monetary transmission mechanism.

This work uses a relatively new modelling strategy developed by Pesaran and Shin (2002). This strategy incorporates the long run structural relationships by testing the theoretical relationships imposed on the cointegrating vectors. The long-run relationships included in the model were based on the Expectations Theory of the term structure of interest rates. The long run structural model was then subjected to the error-correction model, generalised variance decompositions, generalised impulse response functions as well as the persistence profile analyses with a view to finding out more about the linkages between the cash rate and other government interest rates over the period under review.

This work generally indicates that the cash rate and the longer-term rates are cointegrated and form long-run cointegrating relationships, in accordance with the expectation theory. In contrast to the theory, however, it seems that the longer-term rates actually lead changes in the cash rate and other short-term rates, both in the long-run and the short-run, this is indicated by both the error correction and variance decomposition analyses. Some policy implications can be inferred from the results of this study. The unit root tests of the spreads and cointegration tests lend support to the common belief that the long- and short-term interest rates are interconnected.

This study also offers some evidence suggesting that the longer-term rates are exogenous to the system of interest rates and particularly the cash rate. This is contrary to what is generally believed to be the case, which is that the short-term rate leads the longer rates. This finding is particularly relevant to the monetary policy makers. In Australia, monetary policy relies on the hypothesis that the shortest-term rate is exogenous and the idea that changes in the cash-rate will reverberate through the yield curve to the longer-term rates. If it is found that short-term rates react to changes in the long-term rate, and not vice versa, the current method of implementing monetary policy may be inadequate, as without causality from instruments to targets, policy is unlikely to be effective.

The findings that the short-term rate is mostly found to follow (rather than lead) the longer-term rates in Australia need some theoretical/intuitive support. In line with the Fisher equation, the longer-term interest rate is traditionally seen to contain a premium for expected inflation rate. Hence if the monetary authorities are committed to maintaining a low level of inflation (and interest) rate, as was the case with the Australian monetary policy during most of the period since the early 1990s, they are likely to adjust the cash rate in line with the longer-term rates. The findings of this study tend to cast doubts on the efficiency and effectiveness of the current monetary policy in Australia.

5. The concept and practice of carry trade have gained popularity in recent years, particularly since the yen became a very low-interest currency. The paper by I. Moosa, "The Profitability of Carry Trade", makes an attempt to assess the profitability of carry trade using six currency combinations and historical data covering the period December 1999-June 2006, with three objectives: (i) to evaluate the profitability of carry trade in general; (ii) to find out if carry trade is an exclusively yen-based operation; and (iii) to

evaluate the criteria used for the selection of carry trade positions. The results seem to cast doubt on the profitability of carry trade as there is mostly a fifty-fifty chance that profit can be made from a single carry trade operation. The results also show that carry trade is not an exclusively yen-based operation because the interest rate differential is not the only factor determining the profitability of these operations. As a result, a proper criterion for selecting carry trade positions must embody both the interest rate differential and exchange rate volatility.

The poor performance of carry trade, as demonstrated in this paper, would have been worse if one takes into account the bid-offer spreads in interest and exchange rates, as these spreads are identified as a factor that negatively affects the amount of money made on carry trade. A question that arises is the following: how do we reconcile this finding with the empirical failure of uncovered interest parity (UIP)? The answer is simple because, unlike what is typically stated in the literature, the failure of UIP does not necessarily mean that carry trade is profitable. UIP tells us that a high-interest currency will depreciate against a low-interest currency by a percentage that is equal (or close to) the interest rate differential. The failure of UIP could take two forms: (i) the high-interest currency depreciates by less than the interest rate differential or even appreciates, and (ii) the high-interest rate currency depreciates by more than the interest rate differential. The first form of failure produces profitable carry trade, but the second form means a loss is incurred on the underlying carry trade position. It seems, therefore, that over-enthusiasm about carry trade is motivated by no more than herd behaviour. Particularly risky is the mere consideration of the interest rate differential without due regard to exchange rate volatility (hence, the enthusiasm about the yen as the funding currency). There are indeed some myths about the profitability of carry trade.

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