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Etienne Farvaque, Gael Lagadec

**Divided Boards: Partisanship Through Delegated Monetary Policy**
Divided Boards:
Partisanship through Delegated
Monetary Policy

Etienne Farvaque\textsuperscript{y} Gaël Lagadec\textsuperscript{z}

September 10, 2000

Abstract

While monetary policy decisions are mainly taken by Committees (as is the case for the ECB, or for the Federal Reserve), the literature largely stands on the action of a single central banker, be it (or not) a conservative one. The purpose here is to consider explicitly the plural dimension of monetary policy Boards, and to investigate the consequences of such a decision structure for monetary policy rules.

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1. Introduction

Since the first day of the European Central Bank’s life, and even before, observers and commentators have been worried of political pressures on the Bank, but also of opinion divergences inside the Board. The first kind of coercion on monetary policy has been prevented by the adoption of the so-called Stability Pact, even if everybody knows it does not prevent bashing (a term coined by Waller, 1991) exercised by political leaders on the Bank. That should be no surprise, as this kind of ‘chicken’ game between monetary and fiscal policymakers belongs to untold rules of the political scene. Yet, at least on pure theoretical ground, its implications and potential dangers are now well known (see, for example, Persson and Tabellini, 1995).

Hence for political pressures, but what about the divergences of insiders’ opinion? While monetary policy decisions are mainly taken by Committees (as is the case for the ECB, or for the Federal Reserve), it appears that the literature has hardly looked upon the consequences of such a decisional structure. It is rather mainly based on the opposite assumption, of monetary policy being decided and implemented by a single policymaker, be it (or not) a conservative one. However, it is now well documented that “central banks are no united actors”, as Von Hagen (1999, p.682) puts it. This author, for example, even identifies three opposite groups inside the Bundesbank Board, each group having different objectives for monetary policy. Our objective here is thus to integrate explicitly the plural dimension of monetary policy Boards, and to investigate the consequences of such a decision structure for monetary policy rules.

Our framework is a simple one-period model with time consistency problems. We simply depart from the literature by considering delegated monetary policy to a Board where two types of agents confront. We consider the source of divergence to lie in different views (due to ideological influence or simply lack of knowledge) about the functioning of the economy. In the model, this comes from different judgments about the slope of the Phillips curve (the relative efficiency of monetary policy on real variables). We show that, in this context, considering opinion divergences leads to several conclusions. First, we exhibit the possibility of a political business cycle, one that has rarely been highlighted, induced by the appointment of new central bankers at the Board. Second, we show that traditional solutions to the inflation bias (i.e. performance contracts, inflation targets and conservative central bankers) depend on the uncertainty raising from ideological divergences. As a consequence, implementing these solutions should be considered cautiously.
However, we also show, as a third result, that societies will, on average, be better off when monetary policy is delegated to a Board than when it is left to elected leaders.

The first section thus develops the model, and considers monetary policy decisions in the absence of delegation. In the second section, we expose how explicit consideration of Board’s opinions heterogeneity can question traditional solutions to the time consistency problem, in part because of the bank’s appointment induced business cycle. The conclusion follows with reflections on further research.

2. Monetary policy by elected leaders

We start from a standard one-period model of monetary policy with time consistency and stabilization problems, as Barro and Gordon (1983) and Rogoff (1985) first introduced. The model is extended to include electoral uncertainty, as in Alesina (1987, 1988): two political parties compete and, once elected, the (leader of the) winning party selects the monetary policy according to its own preferences. The preferences of each party are given by a loss function assigning a penalty to deviations of inflation from an optimal level, \( \bar{\pi} \), and to deviations of output from a given target \( \bar{y} \):

\[
L^D = \frac{1}{2} h (\pi - \pi^*)^2 + \pm (y - \bar{y})^2 \\
L^R = \frac{1}{2} h (\pi - \pi^*)^2 + \frac{1}{2} (y - \bar{y})^2
\]

Thus, we assume political parties to share the same objectives, but to disagree on their relative weight. We will assume here \( \frac{1}{2} < \pm \) hence party D is relatively more concerned by output stabilization.

Where we depart from the literature is when we consider parties to have divergent preferences because of insufficient (or ideologically oriented) economic knowledge: each party believes the economy to conform to its own views, i.e. each party gives output stabilization a weight conform to its vision of the economic process. We assume the weight given to output stabilization is related (for simplicity, we suppose here it is strictly equal) to the slope of the expectations-augmented Phillips curve:

\[
y^D = \pm (\pi - \pi^e) + "
\]
\[ y^R = \frac{1}{2} (\frac{1}{4} \pm \frac{1}{2}) + " \] (2b)

Output is (traditionally) assumed to be a function of surprise inflation\(^1\), plus a random error shock, ", normally distributed with mean zero and variance equal to \( \frac{1}{2} \). It is the parties’ desire to stabilize output at a level greater than \( y^e \) that creates the time consistency problem, with political competition just adding uncertainty. But here, uncertainty does not only emerge from the political process, but because the political process is driven by ideological perceptions of how the economy works: the bigger each party will perceive the slope of the Phillips curve, the higher it will be incited to stabilize output.

Above hypothesis has - to our knowledge - never been endorsed, either by the time consistency literature or by the political business cycles one. We think that omission drives the literature further from realism, given the existing, still controversial, economic knowledge and given the importance economic variables have in political parties’ platforms, without even mentioning the question of how economic disturbances influence votes. To have neglected that ideological bias, the literature may have proposed solutions to time inconsistency problems that may become critically flawed, as should become clear below.

Within this context, during a period, the sequence of events is the following: first, wage-setters lock in wage contracts; then elections occur. Once elected, the winning party observes shocks hitting the economy and sets up monetary policy (we assume, as standard, the policymaker to control \( \frac{1}{4} \)). When engaging in their contracts, wage-setters must make (rational) prior beliefs about elections results. We assume electoral probabilities to be exogenous, with party R elected with probability \( 1 - q \) and party D with probability \( q \). Hence, everything happens as if the economy could be described by the following process:

\[ y = q y^D + (1 - q) y^R = \frac{1}{2} (\frac{1}{4} \pm \frac{1}{2}) + " \] (3)

where \( \frac{1}{4} \pm (1 - q) \frac{1}{2} \). As shocks cannot be expected by wage-setters, policymakers have a rationale for output stabilization. Of course, in this context, no commitment technology is exploitable, and the discretionary solution applies. Routine optimization under rational expectations (minimizing (1a) and (1b) under (3) and REH) gives the monetary policy chosen by each party, if elected:

\[ \mp = \frac{1}{2} + y^e \frac{4(1 + \frac{1}{3})}{1 + \frac{1}{4}} i \frac{1}{1 + \frac{1}{4}} " \] (4a)

\(^1\)The equilibrium or natural level of output, \( y \), has been normalized at zero.
The solutions come in the traditional form, composed of an inflationary bias and a stabilization policy term. As in Alesina (1987, 1988), the solution is affected by both partisanship and political uncertainty. It is now well-known that increased polarization and (thus) political uncertainty increase both inflation and output fluctuations (see Alesina and Gatti, 1995), a result that also emerges from our slightly modified model. Several solutions have emerged in the literature to light this uncertainty and reduce both the average inflation bias and the politically-induced variance of inflation and output: these range from Rogoff’s (1985) conservative central banker to Walsh’s (1995) optimal contract and Svensson’s (1997) inflation targets. These solutions have been shown to reduce the theoretical time consistency problem and have sometimes been empirically implemented. Yet, to date, they are still hotly debated issues, on purely theoretical grounds as well as relatively to their empirical relevance and implications (see, between others, Waller, 1995, on optimal contracts, Forder, 1998, 1999, on independence, and Mishkin, 1999, on targets).

In our view, the debate is at least partly due to the omission of two empirically important facts of monetary policy decisions: first, they are taken while economists have no consensual views on how and how much money influences the economy (as is clearly perceptible in Walsh, 1998). Second and, we believe, even more consequential, the proposed solutions all lie on the simplifying assumption of a single policymaker deciding on monetary policy. But, concretely, monetary decisions are taken inside Boards, that is to say are taken after being debated in deliberating assemblies. And, as the news and minutes accounts of monetary decisions show, those are sometimes hotly debated ones. Thus, a crude fact is that there is no single-minded central banker, but monetary policy committees. The next section, by endorsing the opposite assumption, shows how painful the action of a single peopled / minded policy Board can be.

3. Delegation to a policy Board

We first consider how opinions heterogeneity inside the Board can influence monetary policy, even opening the door to a certain kind of political business cycle. We then derive the implications for traditional solutions to the time consistency
problem. The section ends in showing why societies may nevertheless profit from delegating policy to a Board.

3.1. Partisanship inside the Board

We will now suppose monetary policy to be delegated to an independent central bank, whose preferences are given by the following loss function:

\[ F = \frac{1}{2} \left( \frac{\dot{y}}{\dot{\pi}} \right)^2 + \mu (y - \bar{y})^2 \]  \hspace{1cm} (5)

which, at least apparently, stands on the traditional assumption of a single policymaker. However, as we believe the reality of policymaking Boards to be a relatively conflicting and partly heterogeneous one, we will consider \( F \) to be the aggregate function of an institution peopled by (to keep things simple) two kinds of deciders, in proportion \( p \) and \((1 - p)\):

\[ F = pL^k + (1 - p) L^c \]  \hspace{1cm} (5')

Central bankers are thus of two kinds, sharing the same objectives but with relative preferences given by:

\[ L^k = \frac{1}{2} \left( \frac{\dot{y}}{\dot{\pi}} \right)^2 + \cdot (y - \bar{y})^2 \]  \hspace{1cm} (6a)

\[ L^c = \frac{1}{2} \left( \frac{\dot{y}}{\dot{\pi}} \right)^2 + \circ (y - \bar{y})^2 \]  \hspace{1cm} (6b)

where we assume: \( \cdot > \circ \), i.e. one kind of policymaker weights more output stabilization than the other one. Hence the central bank global loss function is the weighted aggregation of (6a) and (6b). We will suppose for the moment relative proportions of each kind of deciders to be exogenously given, with \( p \) being the part of deciders of the \( k \) type. In (5), we thus have: \( \mu \cdot p + (1 - p) \circ = p(\cdot \circ) + \circ \). As above, we assume policymakers to disagree about the functioning of the economy, each kind of central banker having in mind a different value for the slope of the Phillips curve when asked about monetary policy decisions:

\[ y^k = \cdot (\ddot{\pi} - \dot{y}) + " \]  \hspace{1cm} (7a)

\[ y^c = \circ (\ddot{\pi} - \dot{y}) + " \]  \hspace{1cm} (7b)
and thus:

\[ y^k + (1 - p) y^c = \mu (\frac{\mu}{1 + \mu^2}) + " \]  
\[ (7c) \]

Equations (7a) and (7b) are related to each kind of central banker, while the last one is the aggregate function applying when collegial decisions are taken.

Everything happens thus as if the preceding competing parties had adopted an independent central bank to avoid politically induced business cycle. However, the agreement included provisions giving each party a given number of seats inside the newly designed policy Board. The committee thus reflects, at least partly, the society’s ideological divisions. The politically induced fluctuations have then been clustered inside the Board, while they preceding were frontpage news.

Another way, which we believe an even more pertinent one, to think about the situation we describe here is the following: suppose letters R and D no longer signal political orientation, but countries. Then, the preceding section would have described a political and monetary union between two historically separated countries (or states or regions), while the present section simply describes an economic and monetary union, with monetary policy decisions taken inside a Board to which each country delegates its central banker (a kind of institution the European Central Bank would be a prominent example of).

While they clearly sound like realistic descriptions, both interpretations are hardly met in the literature, which generally stands on the action of an omnipotent (and sometimes omniscient) central banker deciding alone on inflation and stabilization decisions. When ruling out this assumption, a better description of the policy game in federations or in economic and monetary unions (EMUs) is given by equations (5) to (7c). In this simple framework, discretion still emerges as the equilibrium solution. Minimization of (5) under (7c) and rational expectations delivers:

\[ \frac{\mu}{1 + \mu^2} = \frac{\mu}{1 + \mu^3} + " \]  
\[ (8) \]

Inspection of the solution shows that delegating monetary policy to a Committee nesting people with different (possibly divergent) preferences does not rid

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2 An insight about both types of divergences we consider can be found, respectively, in Moser (1999) and in Alesina and Grilli (1992). But these authors do not derive their policy implications. Von Hagen and Süppel (1994) and Von Hagen (1995) explored possible constitutions for monetary unions, but keep the action of a single-minded central banking Committee as a reference. However, see Waller (1996) who analyzes, though in a different way, policy Boards’ heterogeneity.
inflation of partisanship, embedded here in $\mu$. As long as there can be several interpretations of the economy and / or political polarization, inflation will suffer from a bias, should it be due to a lack of knowledge or coming from ideologically-oriented delegation. As we will see now, this bias may even be the source of a new kind of political business cycle, eroding further the base on which traditional solutions lie.

3.2. Good times, bad times: insights on an inflation-induced political cycle

Remember partisanship being embedded in $\mu = p \cdot (1 \cdot p) \circ$, with $p$ the relative proportion of policymakers caring more about output (one can think, in a quite caricatural way, that they are of a 'keynesian' type, while others are of the 'neo-classical' one). As they are appointed by elected leaders, there may be swings in relative proportions when a member of the Board ends her mandate (or resigns, or dies). With divergent preferences, these appointments may give rise to a new kind of political business cycle, the paradox being that it is truly induced by the delegation process itself. This comes in contradiction with the common wisdom, inspired by Rogoν’s (1985) influential paper, that delegation may increase welfare by reducing uncertainty surrounding inflation and output stabilization.

As an illustration of that point, think of an episode of output contraction, leading to a burst of inflation, as the central bank tries to stabilize output. If some members of the Committee have to be renewed\(^3\), the renewal may be influenced by recent experience, and the relative proportion of ‘keynesians’ versus ‘neoclassics’ will probably be time-varying. In that case, of course, relative proportions become endogenous, $p = p \circ \frac{F}{y}$, with the following intuitive comparative static properties: $\frac{\partial p}{\partial t} < 0$ and $\frac{\partial p}{\partial y} < 0$: following a burst of inflation, preference in renewals should be denied to ‘keynesians’ (should it be due to a preference reversal inside the existing Board or to the appointment of a new, less ‘liberal’, member) and, when output grows far out of the target, fear of inflation will probably have the same impact. Hence, any inflation / output variation will have some consequences on the Board composition, and thus on inflation and output results. As long as there is some uncertainty about the economy, any event can lead to preferences

\(^3\)It does not matter here whether the appointment process may or may not concern the same people. All that is necessary for the reasoning is the only possibility of preferences divergences in the whole society. In the extreme case, as long as at least two people’s views about the economy diverge, our reasoning applies.
reversals: a government can change his view of the economy, thus selecting unlikely people to appoint. As the Board here has no more knowledge than the political parties, we cannot preclude preferences reversal inside the Board either.

Moreover, and inversely, any variation in the inflation performance (from (8), we clearly have $\frac{\partial}{\partial p} > 0$: the more numerous 'keynesians' are, the higher the average inflation). Delegating is thus not enough to forbid uncertainty in monetary policy. As long as policy will be designed by a Committee (i.e. by more than one person), reappointments will occur, opening the door to partisan influence in monetary policy.\(^4\)

One may ask how realistic this scenario is. A simple exercise will help here to make our case more concrete: think of the European Central Bank, with policy decisions taken by a policy Council composed of the Directoire (6 members) and the governor of the central bank of each member of the Euro-zone, 11 people as of 1999. These governors have commonly long, non-renewable, staggering appointments of about eight years on average. Average turnover should then be higher than one a year. Our simple one-period model is thus able to catch majority reversals that could occur at the ECB with, following inflationary (resp. deflationary) episodes, the appointment of a neoclassical (resp. keynesian) -minded central banker.

We should add that giving life mandate would not stabilize the process, as long as some members of the monetary policy Committee could change their minds: after an episode of inflation revival, for some time at least, some "doves" may turn into "hawks", leading to majority (and thus to policy) reversal. The higher the uncertainty about the way the economy functions, the less observers should ignore the probability of ideological conversions.\(^5\)

To sum up, we think that one can not simply preclude political business cycles arguing of central bank independence when Committee members are heterogeneous and/or politically appointed. That conclusion looks even worse when turning to other solutions that have been recently proposed to remove the inflationary bias of monetary policy, as these solutions also lie on the assumption of a single central banker.

\(^4\)This kind of partisan influence may prove less efficient than pure "bashing" (Waller, 1991), while efficiency in our case will depend on the quorum size of the Board. Remember also that partisanship may come from Congressional influence (see Grier, 1991). Of course, all hypotheses are not mutually exclusive.

\(^5\)Von Hagen (1999, pp.692-694) documents such a conversion occurring at the Bundesbank.
3.3. On targets and contracts

Among the proposed solutions to the inflationary bias of discretionary monetary policy, independence, optimal contracts and inflation targets are prominent. However, these solutions make reference to the delegation of monetary policy to a selected central banker taking decisions, alone, about monetary policy. The assumption may not be irrelevant in certain circumstances (when policy decisions are, concretely, taken by one person or in crisis times, when there may be a kind of “rally round the flag”, with members of the monetary Committee ranging behind the Governor’s view). However, in general, we believe the assumption to be harmful, as it delivers solutions that may not be applicable. The “applicability” criticism has already emerged in the literature (and notably for contracts, see McCallum, 1995), but not on the same grounds.

What we will show here is that the targets and contracts solutions, far from reducing uncertainty and distortions emerging from discretionary policy, are subject to partisanship uncertainty.

So, Walsh (1995) showed that, by inflicting to its central bank a penalty indexed on inflation, a society could obtain from it the “right” inflation rate, the optimal one. The contract was then correcting the absence of a pre-commitment technology, in an ex-post way.

Is the contracting solution relevant when monetary policy decisions are made by a Board? In this case, then, the loss function would write:

\[
F^C = \frac{1}{2} (\alpha_i - \alpha)^2 + \mu (y - y)^2 + \gamma^2 \quad (9)
\]

where \(\gamma\) is the penalty coefficient. Solving this problem in the same way as above, one obtains the inflation rule when a contract is in place:

\[
\alpha^C = \alpha + y \mu^2 \quad (10)
\]

Hence, the optimal contract writes:

\[
\gamma = \gamma(\mu) = y \mu^2
\]

The optimal contract can thus be defined, but it depends on the Board’s divergences. Moreover, due to the renewal process, the contract is now state-contingent, and can no longer be used as a pre-commitment technology. This reinforces McCallum’s (1995) criticism stating that the negotiation of the contract between the
bank and the government was just a re-location of the time-consistency problem, as the government always kept an incentive to disavow its (or its predecessor’s) signature. When considering policy Committees with appointment process standing, without even renegotiating the contract, a government can modify its clauses, emptying it from any tenor, simply by using the (re)appointment procedure. The process is rather more subtle here, but no less harmful.

Inflation targets are subject to the same criticism, of course. In that case, the bank is given an objective, \( b_4 \) defined by the government. Her loss function thus writes:

\[
F^T = \frac{1}{2} (\frac{1}{4} i \ b_i^2 + \mu (y - y^\mu)^2)
\]

(11)

Optimization delivers the discretionary solution under a target as:

\[
\frac{1}{4} i^T = b_4 + y^\mu \mu^2 \ i \ \frac{\mu^2}{1 + \mu^2}
\]

To approach the optimal (committed) solution, the government should then define the target as:

\[
b_4 = b_4(\mu) = \frac{1}{4} i \ y^\mu \mu^2
\]

(12)

The problem still lies in the target depending on the Board’s composition (and renewal process). The preceding remarks apply here as well. Targets are contingent to the Committee composition and, as a consequence, may not prove as efficient as claimed as a commitment technology for monetary policy.\(^6\)

The preceding results raise a doubt on the efficiency and relevancy of proposed solutions to the inflation bias, but they also raise a question, lying this time on the positive side: Why does a society delegate monetary policy to a Committee if its members are politically influenced and may even give birth to politically induced business cycles, hence reducing social welfare?

3.4. Why do Boards exist

To understand why Boards may be a rational social choice, let us suppose that the Board reflects political polarization exactly: everything happens here as if political parties of the first section are appointing partisans to the Board, in

\(^6\)Mishkin (1999, p.591) notes that one main advantage of the targeting strategy may come from focusing the political debate on inflation outcomes. However, our argument still stands, as this does not prevent debate inside the Board, even if it may limit the Bank’s margin of maneuver.
proportions equal to their political weight. In that case, we would have: \( R \sim c, D \sim k, q \sim p, (1 - q) \sim (1 - p), \frac{1}{2} \sim \sigma, \pm \sim \cdot, \) and \( \frac{1}{2} \sim \mu. \) Substituting in (4a) and (4b), we have:

\[
\begin{align*}
\frac{1}{2} P \sim k &= \frac{1}{2} + y^n \mu \frac{1 + \mu^3}{1 + \cdot \mu^3} i \frac{\mu}{1 + \mu^2} \\
\frac{1}{2} R \sim c &= \frac{1}{2} + y^n \sigma \frac{1 + \mu^3}{1 + \sigma \mu^3} i \frac{\sigma \mu}{1 + \sigma \mu^2}
\end{align*}
\]

(13a)

(13b)

while delegation to a Committee still delivers \( \frac{1}{2} F, \) which we rewrite for convenience:

\[
\frac{1}{2} F = \frac{1}{2} + y^n \mu^2 i \frac{\mu^2}{1 + \mu^2}
\]

(8)

To know if society is better off with delegation than without, we have to verify that inflation performance is better under delegation. Term by term comparison simply shows that we have:

\[
\frac{1}{2} F \sim c < \frac{1}{2} F < \frac{1}{2} P \sim k
\]

(14)

Hence, delivering monetary policy into the members of a Board’s hands does not systematically make society better off, as inflation may sometimes be higher than with political leaders deciding, delivering higher losses. However, even when the Board reflects society’s political degree of polarization and uncertainty perfectly, delegating monetary policy to a Committee delivers, on average, a better inflation performance. Everything happens as if policy debates were choked off in the central bank’s conditioned rooms, where policy decisions are taken, instead of being debated in the heated air of the political arena.

In brief, while monetary theory should consider more exactly how policy decisions are taken (i.e. by somewhat ideologically influenced people), it seems that societies found in Committees delegation a way to keep policy debates alive but hardly kicking.

4. Conclusion

We have used a simple framework to show how considering that policy Boards are composed of heterogeneous people may be important for monetary economics.
The assumption of a single central banker should be considered as a fiction, a sometimes useful one, but also a sometimes misleading one. We believe the latter option to be true when considering solutions to time consistency problems: all of them (the conservative central banker as well as performance contracts or inflation targets) are based on the fiction, an assumption that plagues their supposed welfare enhancing properties and/or implementability. More work thus needs to be done to consider how effective they may be when people with potentially divergent preferences seat around a Board’s table.7

We identified a (barely mentioned) source of business cycle emerging from the appointment process or from ideological conversions of Board members. This kind of politically induced cycle is probably one of the main impediments for solutions to time consistency problems to be enforced.

On the positive side, including potential divergent preferences may also shed some light into another research area. As Clarida et al. (1999) or Taylor (1999) emphasize, interest rate smoothing is still a puzzle for monetary economists. All things equal, considering insiders divergences may help explain slow movements in interest rates. That hypothesis, at least, should deserve further exploration.

References


7Our conclusion about the relative desirability of targets and contracts joins Muscatelli’s (1998), while achieved with a different set of hypotheses.


<table>
<thead>
<tr>
<th>Year</th>
<th>Title</th>
<th>Author(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>Euro-Diplomatie durch gemeinsame „Wirtschaftsregierung“</td>
<td>Martin Seidel</td>
</tr>
<tr>
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<tr>
<td></td>
<td>Measuring Tax Burdens in Europe</td>
<td>Guntram B. Wolff</td>
</tr>
<tr>
<td></td>
<td>Remittances as Investment in the Absence of Altruism</td>
<td>Gabriel González-König</td>
</tr>
<tr>
<td></td>
<td>Economic Integration in a Multicone World?</td>
<td>Christian Volpe Martincus, Jennifer Pédussel Wu, Jürgen von Hagen, Valeriya Dingler</td>
</tr>
<tr>
<td></td>
<td>Banking Sector (Under?)Development in Central and Eastern Europe</td>
<td>Martin Seidel</td>
</tr>
<tr>
<td></td>
<td>Regulatory Standards Can Lead to Predation</td>
<td>Stefan Lutz</td>
</tr>
<tr>
<td></td>
<td>Währungspolitik als Sozialpolitik</td>
<td>Martin Seidel</td>
</tr>
<tr>
<td></td>
<td>Public Education in an Integrated Europe: Studying to Migrate and Teaching to Stay?</td>
<td>Panu Poutvaara</td>
</tr>
<tr>
<td></td>
<td>Voice of the Diaspora: An Analysis of Migrant Voting Behavior</td>
<td>Jan Fidrmuc, Orla Doyle</td>
</tr>
<tr>
<td></td>
<td>Macroeconomic Adjustment in the New EU Member States</td>
<td>Jürgen von Hagen, Iulia Traistaru</td>
</tr>
<tr>
<td>2004</td>
<td>The Effects of Transition and Political Instability On Foreign Direct Investment Inflows: Central Europe and the Balkans</td>
<td>Josef C. Brada, Ali M. Kutan, Tamer M. Yigit</td>
</tr>
<tr>
<td></td>
<td>The Choice of Exchange Rate Regimes in Developing Countries: A Multinominal Panel Analysis</td>
<td>Jürgen von Hagen, Jizhong Zhou</td>
</tr>
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<td></td>
<td>Fear of Floating and Fear of Pegging: An Empirical Analysis of De Facto Exchange Rate Regimes in Developing Countries</td>
<td>Jürgen von Hagen, Jizhong Zhou</td>
</tr>
<tr>
<td></td>
<td>Der Vollzug von Gemeinschaftsrecht über die Mitgliedstaaten und seine Rolle für die EU und den Beitrittsprozess</td>
<td>Martin Seidel</td>
</tr>
<tr>
<td></td>
<td>Deutschlands Wirtschaft, seine Schulden und die Unzulänglichkeiten der einheitlichen Geldpolitik im Eurosystem</td>
<td>Dieter Spethmann, Otto Steiger</td>
</tr>
<tr>
<td></td>
<td>Fiscal Crises in U.S. Cities: Structural and Non-structural Causes</td>
<td>Guntram B. Wolff</td>
</tr>
<tr>
<td></td>
<td>Firm Performance and Privatization in Ukraine</td>
<td>Galyna Grygorenko, Stefan Lutz</td>
</tr>
<tr>
<td></td>
<td>Analyzing Trade Opening in Ukraine: Effects of a Customs Union with the EU</td>
<td>Oksana Harbuzyuk, Stefan Lutz</td>
</tr>
<tr>
<td></td>
<td>Exchange Rate Risk and Convergence to the Euro</td>
<td>Lucjan T. Orlowski</td>
</tr>
<tr>
<td></td>
<td>The Endogeneity of Money and the Eurosystem</td>
<td>Otto Steiger</td>
</tr>
<tr>
<td></td>
<td>Which Lender of Last Resort for the Eurosystem?</td>
<td>Otto Steiger</td>
</tr>
<tr>
<td></td>
<td>The Effectiveness of Subsidies Revisited: Accounting for Wage and Employment Effects in Business R+D</td>
<td>Volker Reinthaler, Guntram B. Wolff</td>
</tr>
<tr>
<td></td>
<td>Money Market Pressure and the Determinants of Banking Crises</td>
<td>Jürgen von Hagen, Tai-kuang Ho</td>
</tr>
<tr>
<td></td>
<td>Die Stellung der Europäischen Zentralbank nach dem Verfassungsvertrag</td>
<td>Martin Seidel</td>
</tr>
<tr>
<td>B18-04</td>
<td>Transmission Channels of Business Cycles Synchronization in an Enlarged EMU</td>
<td>Iulia Traistaru</td>
</tr>
<tr>
<td>B17-04</td>
<td>Foreign Exchange Regime, the Real Exchange Rate and Current Account Sustainability: The Case of Turkey</td>
<td>Sübidey Togan, Hasan Ersel</td>
</tr>
<tr>
<td>B15-04</td>
<td>Do Economic Integration and Fiscal Competition Help to Explain Local Patterns?</td>
<td>Christian Volpe Martincus</td>
</tr>
<tr>
<td>B14-04</td>
<td>Euro Adoption and Maastricht Criteria: Rules or Discretion?</td>
<td>Jiri Jonas</td>
</tr>
<tr>
<td>B13-04</td>
<td>The Role of Electoral and Party Systems in the Development of Fiscal Institutions in the Central and Eastern European Countries</td>
<td>Sami Yläoutinen</td>
</tr>
<tr>
<td>B12-04</td>
<td>Measuring and Explaining Levels of Regional Economic Integration</td>
<td>Jennifer Pédusse1 Wu</td>
</tr>
<tr>
<td>B11-04</td>
<td>Economic Integration and Location of Manufacturing Activities: Evidence from MERCOSUR</td>
<td>Pablo Sanguinetti, Iulia Traistaru, Christian Volpe Martincus</td>
</tr>
<tr>
<td>B10-04</td>
<td>Economic Integration and Industry Location in Transition Countries</td>
<td>Laura Resmini</td>
</tr>
<tr>
<td>B08-04</td>
<td>European Integration, Productivity Growth and Real Convergence</td>
<td>Taner M. Yigit, Ali M. Kutan</td>
</tr>
<tr>
<td>B06-04</td>
<td>Rural Urban Inequality in Africa: A Panel Study of the Effects of Trade Liberalization and Financial Deepening</td>
<td>Mina Baliamoune-Lutz, Stefan H. Lutz</td>
</tr>
<tr>
<td>B05-04</td>
<td>Money Rules for the Eurozone Candidate Countries</td>
<td>Lucjan T. Orlowski</td>
</tr>
<tr>
<td>B04-04</td>
<td>Who is in Favor of Enlargement? Determinants of Support for EU Membership in the Candidate Countries’ Referenda</td>
<td>Orla Doyle, Jan Fidrmuc</td>
</tr>
<tr>
<td>B03-04</td>
<td>Over- and Underbidding in Central Bank Open Market Operations Conducted as Fixed Rate Tender</td>
<td>Ulrich Bindseil</td>
</tr>
<tr>
<td>B02-04</td>
<td>Total Factor Productivity and Economic Freedom Implications for EU Enlargement</td>
<td>Ronald L. Moomaw, Euy Seok Yang</td>
</tr>
<tr>
<td>B01-04</td>
<td>Die neuen Schutzklauseln der Artikel 38 und 39 des Beitrittsvertrages: Schutz der alten Mitgliedstaaten vor Störungen durch die neuen Mitgliedstaaten</td>
<td>Martin Seidel</td>
</tr>
</tbody>
</table>

**2003**

<p>| B29-03 | Macroeconomic Implications of Low Inflation in the Euro Area | Jürgen von Hagen, Boris Hofmann |
| B28-03 | The Effects of Transition and Political Instability on Foreign Direct Investment: Central Europe and the Balkans | Josef C. Brada, Ali M. Kutan, Taner M. Yigit |
| B25-03 | How Flexible are Wages in EU Accession Countries? | Anna Iara, Iulia Traistaru |
| B24-03 | Monetary Policy Reaction Functions: ECB versus Bundesbank | Bernd Hayo, Boris Hofmann |
| B23-03 | Economic Integration and Manufacturing Concentration Patterns: Evidence from Mercosur | Iulia Traistaru, Christian Volpe Martincus |
| B22-03 | Reformzwänge innerhalb der EU angesichts der Osterweiterung | Martin Seidel |
| B21-03 | Reputation Flows: Contractual Disputes and the Channels for Inter-Firm Communication | William Pyle |
| B20-03 | Urban Primacy, Gigantism, and International Trade: Evidence from Asia and the Americas | Ronald L. Moomaw, Mohammed A. Alwosabi |
| B19-03 | An Empirical Analysis of Competing Explanations of Urban Primacy Evidence from Asia and the Americas | Ronald L. Moomaw, Mohammed A. Alwosabi |</p>
<table>
<thead>
<tr>
<th>Session</th>
<th>Title</th>
<th>Authors</th>
</tr>
</thead>
<tbody>
<tr>
<td>B18-03</td>
<td>The Effects of Regional and Industry-Wide FDI Spillovers on Export of Ukrainian Firms</td>
<td>Stefan H. Lutz, Oleksandr Talavera, Sang-Min Park</td>
</tr>
<tr>
<td>B17-03</td>
<td>Determinants of Inter-Regional Migration in the Baltic States</td>
<td>Mihails Hazans</td>
</tr>
<tr>
<td>B16-03</td>
<td>South-East Europe: Economic Performance, Perspectives, and Policy Challenges</td>
<td>Iulia Traistaru, Jürgen von Hagen</td>
</tr>
<tr>
<td>B15-03</td>
<td>Employed and Unemployed Search: The Marginal Willingness to Pay for Attributes in Lithuania, the US and the Netherlands</td>
<td>Jos van Ommeren, Mihails Hazans</td>
</tr>
<tr>
<td>B14-03</td>
<td>FCIs and Economic Activity: Some International Evidence</td>
<td>Charles Goodhart, Boris Hofmann</td>
</tr>
<tr>
<td>B13-03</td>
<td>The IS Curve and the Transmission of Monetary Policy: Is there a Puzzle?</td>
<td>Charles Goodhart, Boris Hofmann</td>
</tr>
<tr>
<td>B12-03</td>
<td>What Makes Regions in Eastern Europe Catching Up? The Role of Foreign Investment, Human Resources, and Geography</td>
<td>Gabriele Tondl, Goran Vuksic</td>
</tr>
<tr>
<td>B11-03</td>
<td>Die Weisungs- und Herrschaftsmacht der Europäischen Zentralbank im europäischen System der Zentralbanken - eine rechtliche Analyse</td>
<td>Martin Seidel</td>
</tr>
<tr>
<td>B10-03</td>
<td>Foreign Direct Investment and Perceptions of Vulnerability to Foreign Exchange Crises: Evidence from Transition Economies</td>
<td>Josef C. Brada, Vladimír Tomsík</td>
</tr>
<tr>
<td>B09-03</td>
<td>The European Central Bank and the Eurosystem: An Analysis of the Missing Central Monetary Institution in European Monetary Union</td>
<td>Gunnar Heinsohn, Otto Steiger</td>
</tr>
<tr>
<td>B08-03</td>
<td>The Determination of Capital Controls: Which Role Do Exchange Rate Regimes Play?</td>
<td>Jürgen von Hagen, Jizhong Zhou</td>
</tr>
<tr>
<td>B07-03</td>
<td>Nach Nizza und Stockholm: Stand des Binnenmarktes und Prioritäten für die Zukunft</td>
<td>Martin Seidel</td>
</tr>
<tr>
<td>B06-03</td>
<td>Fiscal Discipline and Growth in Euroland. Experiences with the Stability and Growth Pact</td>
<td>Jürgen von Hagen</td>
</tr>
<tr>
<td>B05-03</td>
<td>Reconsidering the Evidence: Are Eurozone Business Cycles Converging?</td>
<td>Michael Massmann, James Mitchell</td>
</tr>
<tr>
<td>B04-03</td>
<td>Do Ukrainian Firms Benefit from FDI?</td>
<td>Stefan H. Lutz, Oleksandr Talavera</td>
</tr>
<tr>
<td>B03-03</td>
<td>Europäische Steuerkoordination und die Schweiz</td>
<td>Stefan H. Lutz</td>
</tr>
<tr>
<td>B02-03</td>
<td>Commuting in the Baltic States: Patterns, Determinants, and Gains</td>
<td>Mihails Hazans</td>
</tr>
<tr>
<td>B01-03</td>
<td>Die Wirtschafts- und Währungsunion im rechtlichen und politischen Gefüge der Europäischen Union</td>
<td>Martin Seidel</td>
</tr>
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</table>

**2002**

<table>
<thead>
<tr>
<th>Session</th>
<th>Title</th>
<th>Authors</th>
</tr>
</thead>
<tbody>
<tr>
<td>B30-02</td>
<td>An Adverse Selection Model of Optimal Unemployment Assurance</td>
<td>Marcus Hagedorn, Ashok Kaul, Tim Mennel</td>
</tr>
<tr>
<td>B29B-02</td>
<td>Trade Agreements as Self-protection</td>
<td>Jennifer Pédussel Wu</td>
</tr>
<tr>
<td>B29A-02</td>
<td>Growth and Business Cycles with Imperfect Credit Markets</td>
<td>Debajyoti Chakrabarty</td>
</tr>
<tr>
<td>B28-02</td>
<td>Inequality, Politics and Economic Growth</td>
<td>Debajyoti Chakrabarty</td>
</tr>
<tr>
<td>B27-02</td>
<td>Poverty Traps and Growth in a Model of Endogenous Time Preference</td>
<td>Debajyoti Chakrabarty</td>
</tr>
<tr>
<td>B26-02</td>
<td>Monetary Convergence and Risk Premiums in the EU Candidate Countries</td>
<td>Lucjan T. Orlowski</td>
</tr>
<tr>
<td>B24-02</td>
<td>The Effects of Quotas on Vertical Intra-industry Trade</td>
<td>Stefan Lutz</td>
</tr>
<tr>
<td>B23-02</td>
<td>Legal Aspects of European Economic and Monetary Union</td>
<td>Martin Seidel</td>
</tr>
<tr>
<td>B22-02</td>
<td>Der Staat als Lender of Last Resort - oder: Die Achillesverse des Eurosystems</td>
<td>Otto Steiger</td>
</tr>
<tr>
<td>B21-02</td>
<td>Nominal and Real Stochastic Convergence Within the Transition Economies and to the European Union: Evidence from Panel Data</td>
<td>Ali M. Kutan, Taner M. Yigit</td>
</tr>
</tbody>
</table>
Jürgen von Hagen, Rolf R. Strauch, Guntram B. Wolff

Iulia Traistaru, Guntram B. Wolff

Laura Resmini

Iulia Traistaru, Peter Nijkamp, Simonetta Longhi

Matthias Brückner, Andreas Schaber

Christian E. Wellner, Adam Hersch

Jürgen von Hagen, Jizhong Zhou

Gunnar Heinsohn, Otto Steiger

Martin Seidel

Volker Clausen, Bernd Hayo

Ali M. Kutan, Su Zhou

Martin Seidel

Su Zhou, Ali M. Kutan

Josef C. Brada, Ali M. Kutan, Su Zhou

Volker Clausen, Bernd Hayo

Jürgen von Hagen, Jizhong Zhou

Karlheinz Ruckriegel, Franz Seitz

Manfred J. M. Neumann, Jürgen von Hagen

Karlygash Kuralbayeva, Ali M. Kutan, Michael L. Wyzan

Deutsch-Französisches Wirtschaftspolitisches Forum

Bernd Hayo, Ali M. Kutan

Konstantinos Drakos, Ali M. Kutan

Lucjan T. Orlowski

Jarko and Jan Fidrmuc

Jan Fidrmuc

Matthias Brückner

Josef C. Brada, Ali M. Kutan

Anna Rubinchik-Pessach

R.W. Hafer, Ali M. Kutan
B18-01  Monetary Policy in Unknown Territory. The European Central Bank in the Early Years  Jürgen von Hagen, Matthias Brückner

B17-01  Executive Authority, the Personal Vote, and Budget Discipline in Latin American and Carribean Countries  Mark Hallerberg, Patrick Marier

B16-01  Sources of Inflation and Output Fluctuations in Poland and Hungary: Implications for Full Membership in the European Union  Selahattin Dibooglu, Ali M. Kutan

B15-01  Programs Without Alternative: Public Pensions in the OECD  Christian E. Weller

B14-01  Formal Fiscal Restraints and Budget Processes As Solutions to a Deficit and Spending Bias in Public Finances - U. S. Experience and Possible Lessons for EMU  Rolf R. Strauch, Jürgen von Hagen

B13-01  German Public Finances: Recent Experiences and Future Challenges  Jürgen von Hagen, Rolf R. Strauch

B12-01  The Impact of Eastern Enlargement On EU-Labour Markets. Pensions Reform Between Economic and Political Problems  Deutsch-Französisches Wirtschaftspolitisches Forum

B11-01  Inflationary Performance in a Monetary Union With Large Wage Setters  Lilia Cavallar


B09-01  Democracy in Transition Economies: Grease or Sand in the Wheels of Growth?  Jan Fidrmuc

B08-01  The Functioning of Economic Policy Coordination  Jürgen von Hagen, Susanne Mundschenk

B07-01  The Convergence of Monetary Policy Between Candidate Countries and the European Union  Josef C. Brada, Ali M. Kutan

B06-01  Opposites Attract: The Case of Greek and Turkish Financial Markets  Konstantinos Drakos, Ali M. Kutan

B05-01  Trade Rules and Global Governance: A Long Term Agenda. The Future of Banking.  Deutsch-Französisches Wirtschaftspolitisches Forum

B04-01  The Determination of Unemployment Benefits  Rafael di Tella, Robert J. MacCulloch

B03-01  Preferences Over Inflation and Unemployment: Evidence from Surveys of Happiness  Michele Fratianni, Jürgen von Hagen

B02-01  The Konstanz Seminar on Monetary Theory and Policy at Thirty  Etienne Farvaque, Gael Lagadec

B01-01  Divided Boards: Partisanship Through Delegated Monetary Policy  Etienne Farvaque, Gael Lagadec

2000

B20-00  Breakin-up a Nation, From the Inside  Etienne Farvaque

B19-00  Income Dynamics and Stability in the Transition Process, general Reflections applied to the Czech Republic  Jens Hölscher

B18-00  Budget Processes: Theory and Experimental Evidence  Karl-Martin Ehrhart, Roy Gardner, Jürgen von Hagen, Claudia Keser, Martin Seidel

B17-00  Rückführung der Landwirtschaftspolitik in die Verantwortung der Mitgliedsstaaten? - Rechts- und Verfassungsfragen des Gemeinschaftsrechts  Christa Randzio-Plath, Tomasso Padoa-Schioppa

B16-00  The European Central Bank: Independence and Accountability  Jürgen von Hagen, Ralf Hepp

B15-00  Regional Risk Sharing and Redistribution in the German Federation  Selahattin Dibooglu, Ali M. Kutan

B14-00  Sources of Real Exchange Rate Fluctuations in Transition Economies: The Case of Poland and Hungary  Nauro F. Campos

B13-00  Back to the Future: The Growth Prospects of Transition Economies Reconsidered
<table>
<thead>
<tr>
<th>Title</th>
<th>Author(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rechtsetzung und Rechtsangleichung als Folge der Einheitlichen</td>
<td>Martin Seidel</td>
</tr>
<tr>
<td>Europäischen Währung</td>
<td></td>
</tr>
<tr>
<td>A Dynamic Approach to Inflation Targeting in Transition Economies</td>
<td>Lucjan T. Orlowski</td>
</tr>
<tr>
<td>The Importance of Domestic Political Institutions: Why and How</td>
<td>Marc Hallerberg</td>
</tr>
<tr>
<td>Belgium Qualified for EMU</td>
<td></td>
</tr>
<tr>
<td>Rational Institutions Yield Hysteresis</td>
<td>Rafael Di Tella, Robert MacCulloch</td>
</tr>
<tr>
<td>The Effectiveness of Self-Protection Policies for Safeguarding</td>
<td>Kenneth Kletzer</td>
</tr>
<tr>
<td>Emerging Market Economies from Crises</td>
<td></td>
</tr>
<tr>
<td>Financial Supervision and Policy Coordination in The EMU</td>
<td>Deutsch-Französisches Wirtschaftspolitisches</td>
</tr>
<tr>
<td>The Demand for Money in Austria</td>
<td>Bernd Hayo</td>
</tr>
<tr>
<td>Liberalization, Democracy and Economic Performance during Transition</td>
<td>Jan Fidrmuc</td>
</tr>
<tr>
<td>A New Political Culture in The EU - Democratic Accountability of the</td>
<td>Christa Randzio-Plath</td>
</tr>
<tr>
<td>ECB</td>
<td></td>
</tr>
<tr>
<td>Integration, Disintegration and Trade in Europe: Evolution of Trade</td>
<td>Jarko Fidrmuc, Jan Fidrmuc</td>
</tr>
<tr>
<td>Relations during the 1990’s</td>
<td></td>
</tr>
<tr>
<td>Inflation Bias and Productivity Shocks in Transition Economies:</td>
<td>Josef C. Barda, Arthur E. King, Ali M. Kutan</td>
</tr>
<tr>
<td>The Case of the Czech Republic</td>
<td>Kenneth Kletzer, Jürgen von Hagen</td>
</tr>
<tr>
<td>Monetary Union and Fiscal Federalism</td>
<td></td>
</tr>
<tr>
<td>Skills, Labour Costs, and Vertically Differentiated Industries: A</td>
<td>Stefan Lutz, Alessandro Turrini</td>
</tr>
<tr>
<td>General Equilibrium Analysis</td>
<td></td>
</tr>
<tr>
<td>Micro and Macro Determinants of Public Support for Market Reforms</td>
<td>Bernd Hayo</td>
</tr>
<tr>
<td>in Eastern Europe</td>
<td></td>
</tr>
<tr>
<td>What Makes a Revolution?</td>
<td>Robert MacCulloch</td>
</tr>
<tr>
<td>Informal Family Insurance and the Design of the Welfare State</td>
<td>Rafael Di Tella, Robert MacCulloch</td>
</tr>
<tr>
<td>Partisan Social Happiness</td>
<td>Rafael Di Tella, Robert MacCulloch</td>
</tr>
<tr>
<td>The End of Moderate Inflation in Three Transition Economies?</td>
<td>Josef C. Brada, Ali M. Kutan</td>
</tr>
<tr>
<td>Subnational Government Bailouts in Germany</td>
<td>Helmut Seitz</td>
</tr>
<tr>
<td>The Evolution of Monetary Policy in Transition Economies</td>
<td>Ali M. Kutan, Josef C. Brada</td>
</tr>
<tr>
<td>Why are Eastern Europe’s Banks not failing when everybody else’s</td>
<td>Christian E. Weller, Bernard Morzuch</td>
</tr>
<tr>
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<td></td>
</tr>
<tr>
<td>Stability of Monetary Unions: Lessons from the Break-Up of</td>
<td>Jan Fidrmuc, Julius Horvath and Jarko Fidrmuc</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td></td>
</tr>
<tr>
<td>Multinational Banks and Development Finance</td>
<td>Christian E. Weller and Mark J. Scher</td>
</tr>
<tr>
<td>Financial Crises after Financial Liberalization: Exceptional</td>
<td>Christian E. Weller</td>
</tr>
<tr>
<td>Circumstances or Structural Weakness?</td>
<td></td>
</tr>
<tr>
<td>Industry Effects of Monetary Policy in Germany</td>
<td>Bernd Hayo and Birgit Uhlenbrock</td>
</tr>
<tr>
<td>Financial Fragility or What Went Right and What Could Go Wrong</td>
<td>Christian E. Weller and Jürgen von Hagen</td>
</tr>
<tr>
<td>in Central European Banking?</td>
<td></td>
</tr>
<tr>
<td>Size Distortions of Tests of the Null Hypothesis of Stationarity:</td>
<td>Mehmet Caner and Lutz Kilian</td>
</tr>
<tr>
<td>Evidence and Implications for Applied Work</td>
<td></td>
</tr>
<tr>
<td>Financial Supervision and Policy Coordination in the EMU</td>
<td>Deutsch-Französisches Wirtschaftspolitisches</td>
</tr>
<tr>
<td>Financial Liberalization, Multinational Banks and Credit Supply:</td>
<td>Christian Weller</td>
</tr>
<tr>
<td>The Case of Poland</td>
<td></td>
</tr>
<tr>
<td>Monetary Policy, Parameter Uncertainty and Optimal Learning</td>
<td>Volker Wieland</td>
</tr>
<tr>
<td>The Connection between more Multinational Banks and less Real</td>
<td>Christian Weller</td>
</tr>
<tr>
<td>Credit in Transition Economies</td>
<td></td>
</tr>
<tr>
<td>Year</td>
<td>Title</td>
</tr>
<tr>
<td>------</td>
<td>----------------------------------------------------------------------</td>
</tr>
<tr>
<td>1998</td>
<td>Comovement and Catch-up in Productivity across Sectors: Evidence from the OECD</td>
</tr>
<tr>
<td></td>
<td>Productivity Convergence and Economic Growth: A Frontier Production Function Approach</td>
</tr>
<tr>
<td></td>
<td>Tumbling Giant: Germany's Experience with the Maastricht Fiscal Criteria</td>
</tr>
<tr>
<td></td>
<td>The Finance-Investment Link in a Transition Economy: Evidence for Poland from Panel Data</td>
</tr>
<tr>
<td></td>
<td>The Macroeconomics of Happiness</td>
</tr>
<tr>
<td></td>
<td>The Consequences of Labour Market Flexibility: Panel Evidence Based on Survey Data</td>
</tr>
<tr>
<td></td>
<td>The Excess Volatility of Foreign Exchange Rates: Statistical Puzzle or Theoretical Artifact?</td>
</tr>
<tr>
<td></td>
<td>Labour Market + Tax Policy in the EMU</td>
</tr>
<tr>
<td></td>
<td>Can Taxing Foreign Competition Harm the Domestic Industry?</td>
</tr>
<tr>
<td></td>
<td>Free Trade and Arms Races: Some Thoughts Regarding EU-Russian Trade</td>
</tr>
<tr>
<td></td>
<td>Fiscal Policy and Intranational Risk-Sharing</td>
</tr>
<tr>
<td></td>
<td>Price Stability and Monetary Policy Effectiveness when Nominal Interest Rates are Bounded at Zero</td>
</tr>
<tr>
<td></td>
<td>Die Bewertung der &quot;dauerhaft tragbaren öffentlichen Finanzlage&quot;der EU Mitgliedstaaten beim Übergang zur dritten Stufe der EWWU</td>
</tr>
<tr>
<td></td>
<td>Exchange Rate Regimes in the Transition Economies: Case Study of the Czech Republic: 1990-1997</td>
</tr>
<tr>
<td></td>
<td>Der Wettbewerb der Rechts- und politischen Systeme in der Europäischen Union</td>
</tr>
<tr>
<td></td>
<td>U.S. Monetary Policy and Monetary Policy and the ESCB</td>
</tr>
<tr>
<td></td>
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