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Title

Exchange rates and macroeconomic shocks in Central European countries: Evidence from the Bayesian SVAR models with common serial correlation

Abstract

Though the Visegrad countries and Slovenia acceded the EU jointly in the spring 2004 they adopted different strategies of monetary integration with the euro area. Slovenia and Slovakia adopted the euro relatively quickly whereas the other countries have not included their currencies in the ERM II yet. Thus, the degree of exchange rate flexibility has been quite different across the Central European countries. At the same time capital flows have been liberalised at the accession to the EU or earlier. Against a backdrop of differences in the monetary policy options chosen a set of interesting questions arises: What was the nature of shocks that hit Central European countries? What were the sources of real exchange rate movements? Were flexible exchange rates acting as a shock absorber or rather a shock-propagating mechanism? Does the exchange ERM II insulate against financial shocks?

These questions are addressed by examining the real exchange rates, output, real interest rates and prices in the Visegrad countries and Slovenia over 1998-2013. As a theoretical framework we use the macroeconomic model of an open economy that is based on models developed by Dornbusch (1976) oraz Clarida and Galí (1994). The model is extended to allow for financial shocks. For each country we build a set of Bayesian structural VAR models, that allows us to identify supply, demand, monetary and financial shocks. The shocks are identified through imposing both zero and sign restrictions on the long-run responses of variables to shocks. Additionally, we allow for common serial correlation (see, e.g. Engle, Kozicki, 1993), which can influence short-run reactions of variables to exogenous disturbances.