Non-technical summary

This paper provides an accounting of the sources of differentials in monetary policy stance across euro area members between 1999 and 2008. The investigation gravitates around a decomposition of residuals from an ideal monetary policy rule, mimicking the reaction of the European Central Bank (ECB) to inflation and output gap for individual members of the euro area. The analysis starts with the derivation of a synthetic index measuring the average tightness of monetary policy across euro-zone members; the index is constructed using pseudo-Taylor residuals, obtained from an estimated monetary policy rule for the whole euro area and country specific fundamentals. This measure is then decomposed to disentangle the role of inflation and fundamental economic dynamics. A number of results stand out from the analysis: first, I found evidence of significant differences in average monetary policy tightness across euro area members between 1999 and 2008, with countries such as Ireland, Portugal and Spain experiencing a relatively loose stance with respect to other euro-zone members. Second, such differences can be primarily explained by wedges in inflation, with respect to fluctuations in real output; finally, most of price differentials are due to non-fundamental dynamics, and thus not related to changes in real marginal costs. Results in this paper question the adequacy of using a single monetary policy tool for insuring an adequate policy stance to all euro-zone members. For the purpose of achieving balanced cross-country price dynamics, European policy makers should devote time to the characterization and implementation of policy actions that are both able to ensure a tighter control on non-fundamental price dynamics and offer the possibility of being implemented selectively and on local basis.