Summary

Paleologos, John M., and Papazoglou, Christos

"An Econometric Investigation of Currency Substitution and Capital Mobility in a Two-Country Portfolio-Balance Financial Asset Model"

This paper examines the extent to which the demand for money in the euro area responds to external economic developments. The euro area money demand is derived from a two-country portfolio balance framework with the US being the foreign economy, using quarterly data covering the 1990Q1-2006Q2 period. First, we tested for the existence of structural breaks. The move to the single currency in January 1999 allowed us to consider two sub-periods: 1990Q1-1998Q4 and 1999Q1-2006Q2. During the first, we see a relatively stable demand function, while in the second it appears to be less stable. This is largely due to the fact that the adoption of the single currency brought greater economic integration. Then, we use a multivariate vector autoregressive model (MVAR model). The results reveal significant degree of monetary interdependence during the second sub-period stemming from currency substitution and capital mobility. This, in turn, calls for further international monetary coordination to maintain stable growth in the aggregate money supply in order to properly monitor price stability. (JEL E41, E58, F41)