

Financial markets in CEE countries and their role in transmission of domestic and foreign monetary policy shocks

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Abstract

Large dependence of Central and Eastern European (CEE) countries on monetary policy changes in euro area as well as globalizing financial markets raise questions on the role of the latter in the CEE economies and transmission of monetary policy shocks. This paper uses the VAR methodology for the analysis of stock, bond, and exchange rate markets in six Central and Eastern European countries. First, we study the influence of shocks occurring in each market on domestic economic conditions. Next, the counter-factual simulation analysis is carried out in order to discern the role of the financial markets in the transmission of domestic and European Central Bank's (ECB) monetary policy shocks into CEE economies. The main results point at large diversity across CEE countries, both in case of the effects of financial market shocks on the economy and the transmission channel study. We draw conclusions on the relatively lower importance of bond market and higher importance of stock and exchange rate markets in influencing CEE countries economic conditions. The study of transmission channels also points at stock markets the main channel of transmission, especially in case of output. Transmission of monetary shocks to inflation takes places mainly through stock and exchange rate markets. The results provide implications for both policymakers as well as investors concerned with financial assets of CEE countries.

Keywords: monetary transmission mechanism, financial markets, VAR, counter-factual simulation

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