

THE IMPACT OF DEMAND AND SUPPLY SHOCKS FROM EMU ON BUSINESS CYCLES OF CENTRAL AND EASTERN EUROPEAN COUNTRIES

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NON-TECHNICAL SUMMARY

This paper aims at analysing correlation of demand and supply shocks between the euro area and central and eastern European countries (CEEC) in order to see whether there is some degree of business cycles coordination between them. The main interest is to investigate the impact on Croatia and compare it with other CEECs. Croatia is of interest in this paper since there is a lack of empirical research on this topic which include Croatia in their sample. Information on the correlation of demand and supply shocks between the European monetary union and CEECs is important if a country wants to join a monetary union, since synchronisation of business cycles and policy coordination will have significant impact on willingness to enter to the monetary union (except if the decision is political one). And since Croatia has started its road towards the European Union, it should be expected that Croatia will introduce the euro, since there is no opt out clause for new members.

In order to gather results, supply and demand shocks are extracted from real GDP growth and inflation data using Blanchard and Quah (1989) methodology and then correlations of shocks between the euro area and CEECs are calculated as well as size of shocks and speed of adjustments. Results indicate that Croatia is at the moment far from being ready for the common monetary policy with the euro area, i.e. its correlation of demand and supply shocks with the euro area is low and at the same time Croatia experiences shocks that are on average much larger than in the euro area. Among other CEE countries, Slovenia and Latvia, which in fact first applied for the introduction of euro, have the closest connection of their business cycle with the euro area. Recommendation for the other CEE countries is not to hurry with the introduction of the euro. This advice, however, will not follow Slovakia, which even though does not have correlated supply and demand shocks with the euro area, will introduce the euro in 2009.

Keywords: demand and supply shocks, correlations, euro area, CEE countries, Croatia