

# Price Dispersion in the Euro Area: The Case of a Symmetric Oil Price Shock

KAI CARSTENSEN  
OLIVER HÜLSEWIG  
TIMO WOLLMERSHÄUSER

CESIFO WORKING PAPER NO. 2718  
CATEGORY 7: MONETARY POLICY AND INTERNATIONAL FINANCE  
JULY 2009

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# Price Dispersion in the Euro Area: The Case of a Symmetric Oil Price Shock

## Abstract

This paper studies the causes of price dispersion in the euro area emerging in response to a shock that hits all member countries symmetrically. We use a panel VAR model which is estimated over the period 1996–2007 to generate impulse responses of a range of price and wage variables to an oil price shock. We split our sample of countries into two disjoint groups according to the impact of the oil price shock on the overall price level. While cross-country heterogeneity in the short-run pass-through can be attributed to different weights of energy items in the consumption basket, heterogeneity in the medium-run response of consumer prices is mainly due to a different response of wages and salaries in the industry sector, which can be attributed to different degrees of price and wage rigidities in the member countries.

JEL Code: C32, C33, E31.

Keywords: pass-through, oil price shock, euro area inflation, heterogeneity, panel VAR model.

*Kai Carstensen*  
*Ifo Institute for Economic Research at the*  
*University of Munich*  
*Poschingerstrasse 5*  
*81679 Munich*  
*Germany*  
*carstensen@ifo.de*

*Oliver Hülsewig*  
*Ifo Institute for Economic Research at the*  
*University of Munich*  
*Poschingerstrasse 5*  
*81679 Munich*  
*Germany*  
*huelsewig@ifo.de*

*Timo Wollmershäuser*  
*Ifo Institute for Economic Research at the*  
*University of Munich*  
*Poschingerstrasse 5*  
*81679 Munich*  
*Germany*  
*wollmershaeuser@ifo.de*

July 3, 2009

# 1 Introduction

The European Central Bank (ECB) is mandated to maintain price stability in the euro area as a whole. However, unless the European Monetary Union (EMU) is a homogenous economic entity, stabilization at the aggregate level does not preclude that the member countries are affected in different ways by a common exogenous disturbance, such as an oil price shock (European Central Bank, 2005). As a particular concern for monetary policy, differences in national economic structures and rigidities may cause price adjustments to deviate from each other across countries. While temporary price dispersion is not necessarily harmful to euro area economies, persistent heterogeneity in the adjustment of prices can trigger undesirable consequences such as long-lasting distortions in the development of relative prices across the member states that can lead to welfare losses for individual countries.

Potential causes for inflation dispersion in the euro area are discussed, among others, by European Central Bank (2003) and Hofmann and Remsperger (2005). First, inflation differentials in a currency union may arise from price level convergence, either because tradable goods prices converge as a result of increased trade integration or because non-tradable goods prices converge in the wake of real income convergence. Second, countries may be hit by asymmetric shocks as discussed extensively in the literature on optimum currency areas (see, e.g., Mongelli, 2005, and the references therein). Finally, symmetric shocks may evoke different adjustment processes across countries.

In this paper, by analyzing the effects of oil price shocks that originate on world oil markets and hit all countries to the same extent, we concentrate on the latter question, namely, whether a symmetric shock causes asymmetric price adjustment in the euro area. There are at least two possible reasons for this scenario. Most obviously, different weights of crude oil in the production process and in the consumption basket will provoke different reactions to an oil price shock. However, if the economies are flexible, the adjustment of relative prices will take only a few quarters to restore an equilibrium.

In contrast, price dispersion may also arise from different degrees of national structural inefficiencies such as imperfect factor mobility or price and wage setting

rigidities that give rise to long-lasting distortions in relative prices after exogenous shocks. The empirical evidence on the heterogeneity of price and wage adjustments across euro area countries is large: While for example Altissimo, Ehrmann, and Smets (2006) and Angeloni and Ehrmann (2007) (just to mention two out of a wide range of papers) show that inflation persistence varies markedly across countries, Arpaia and Pichelmann (2007) and Andersson et al. (2008) provide evidence on heterogeneous wage formation processes in the euro area.

The existence of different degrees of national structural inefficiencies has important consequences for the single monetary policy in a currency union. Even if the ECB succeeds to restore price stability in the medium term, this does not guarantee that all economies operate at the efficient frontier (Dellas and Tavlas, 2005). For an inflation targeting central bank in a currency union Benigno (2004) showed that if the degrees of rigidities are different across countries, monetary policy should attach a higher weight to the country with a higher degree of rigidity.

This paper empirically investigates the effects of an oil price shock on consumer prices. Based on a panel vector autoregressive (VAR) model that includes 11 euro area countries, we generate impulse responses of consumer prices to an unanticipated increase in the oil price taking account of additional macroeconomic variables – real GDP, the nominal short-term interest rate and the real effective exchange rate – that might be relevant. We also extend our baseline specification by a number of additional variables, which include producer prices, several sub-components of the consumer price index and real labor costs of the industry and service sector to gain an insight into the transmission of the oil price shock through the economy.<sup>1</sup>

Since the time period of the data that we consider is short, ranging from

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<sup>1</sup>VAR-based analyses of the pass-through from oil price shocks to consumer prices in the euro area are scarce. We are only aware of two papers. Hahn (2003) studies the impact of oil price shocks (and other external shocks) to euro area inflation at different stages of distribution (import prices, producer prices, consumer prices) using aggregate euro area data for the period from 1970 to 2002. She finds that external shocks explain a large fraction of the variance of prices. Peersman and Van Robays (2008) examine the transmission of oil price shocks to euro area inflation by estimating VAR models for both, the aggregate euro area and each individual euro area member country for the period from 1986 to 2007. They find that inflation is largely driven by second-round effects of increasing wages and that there are substantial asymmetries across countries, which are mainly due to different labor market dynamics.

1996Q1 to 2007Q4, we use cross-sectional information to obtain better estimates of the parameters. We select this period for three reasons. First, harmonized data, which allows a detailed cross-country analysis of the transmission of an oil price shock to consumer prices, is provided by Eurostat only from 1996 on. Second, the behavior of labor unions in response to oil price shocks today is very different from the 1970s and 1980s, which must be taken appropriately into account when estimating VAR models over the last two or three decades (Blanchard and Galí, 2007). Finally, we also expect a common reaction of the national central banks to oil price shocks in the period directly preceding the beginning of the single monetary policy, as most of the euro area countries successfully terminated their disinflation policy in the mid-1990s and followed a fixed exchange rate policy vis-à-vis the German mark from then on.

To detect heterogeneities in the transmission of a structural shock in the context of a panel VAR model we suggest a data-driven approach that clusters countries into disjoint groups according to the impact of the oil price shock on the overall price level. We split our sample of countries into two groups – a *high pass-through group* and a *low pass-through group* – that are endogenously identified by using a distance measure, which is determined by the absolute value of the difference between cumulated impulse responses of the overall price level. We consider the responses of consumer prices over different horizons, focusing on the oil price pass-through into national prices in the short- and the medium-run after the occurrence of the shock.

Our findings indicate that the response of consumer prices is very heterogeneous across member countries. Differences in the short-run pass-through can be attributed to the weight of energy items in the consumption basket. However, heterogeneity in the medium-run response of consumer prices is mainly due to different responses of wages and salaries in the industry sector, which is an indication of different degrees of price and wage rigidities in the member countries.

The remainder of the paper is organized as follows. In Section 2, a baseline panel VAR model is estimated under the assumption of homogeneous reactions across countries to an oil price shock. To study the transmission mechanism, the impulse responses of a wide range of price and wage variables are computed. In Section 3 the homogeneity assumption is dropped. Instead, two disjoint groups

of countries are identified that exhibit different consumer price reactions to an oil price shock. It is shown how these differences can be traced back to the heterogeneity in the transmission mechanism which in turn can be explained by structural differences like the the weight of energy in the consumption basket and the wage setting process. Section 4 provides concluding remarks.

## 2 Baseline Model

We start the analysis under the assumption that the euro area countries react homogeneously to an oil price shock. In particular, we assume that country-specific intercepts are sufficient to account for cross-country differences. The main use of this baseline model is to deliver first insights into the transmission mechanism and to serve as a benchmark for the models estimated in the subsequent section under the hypothesis of heterogeneity.

For the baseline model, we employ a panel VAR model of the form

$$X_{i,t} = c_i + \sum_{j=1}^p A_j X_{i,t-j} + \varepsilon_{i,t}, \quad (1)$$

where  $X_{i,t}$  is a vector of endogenous variables for country  $i$ ,  $c_i$  is a vector of country-specific intercepts,  $A_j$  is a matrix of autoregressive coefficients for lag  $j$ ,  $p$  is the number of lags and  $\varepsilon_{i,t}$  is a vector of error terms. The vector  $X_{i,t}$  consists of five variables

$$X_{i,t} = [oil_{i,t}, sti_{i,t}, gdp_{i,t}, reer_{i,t}, hicmp_{i,t}]', \quad (2)$$

where  $oil_{i,t}$  denotes the oil price measured in euro,  $sti_{i,t}$  denotes the nominal short-term interest rate, which serves as the policy instrument of the central bank,  $gdp_{i,t}$  denotes real GDP,  $reer_{i,t}$  denotes the real effective exchange rate, and  $hicmp_{i,t}$  denotes the overall price level as measured by the Harmonized Consumer Price Index (HICP). For each variable, we use a pooled set of  $M \cdot T$  observations, where  $M$  denotes the number of countries and  $T$  denotes the number of observations corrected for the number of lags  $p$ .

Our sample comprises  $M = 11$  euro area countries: Austria (AT), Belgium (BE), Finland (FI), France (FR), Germany (DE), Greece (GR), Ireland (IE),

Italy (IT), the Netherlands (NL), Portugal (PT) and Spain (ES). The data is taken from the Eurostat database, except for the real effective exchange rate, which is from the database of the Bank for International Settlements, and the oil price, which is from the Reuters EcoWin database.<sup>2</sup> The *hicp* series have been seasonally adjusted using Census X12. All variables are expressed in logs except the nominal short-term interest rate that is expressed in percent. The variables are linearly de-trended for each country separately. The data runs from 1996Q1 to 2007Q4 which is the maximum sample for which harmonized euro area data are available. We use a lag order of  $p = 4$ , which ensures that the residuals are free of first-order autocorrelation as indicated by the LM test of Baltagi (2005, pp. 97).<sup>3</sup>

The panel VAR model is estimated via OLS. This is appropriate because the time series dimension (48 quarters) is large relative to the cross section dimension (11 countries). Hence, we do not have to resort to GMM techniques advocated for dynamic panel equations with large  $M$  and small  $T$  (Baltagi, 2005).

On the basis of the VAR model (1) we generate impulse responses of the variables to an oil price shock, which is identified by imposing a triangular orthogonalization with the oil price ordered first. This implies that the other variables are contemporaneously affected by an oil price shock but the oil price is not immediately affected by other shocks. This identification assumption is justified because the oil price is determined on the world market and most likely not by the developments in a specific country, particularly not in the very short run.<sup>4</sup>

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<sup>2</sup>The oil price refers BFO crude oil, which is composed of the three North Sea grades Brent, Forties and Oseberg.

<sup>3</sup>The results of these tests are available from the authors upon request.

<sup>4</sup>There is currently a debate in the literature about the appropriate identification of an oil price shock. Our approach is closely related to Blanchard and Galí (2007). Other identification approaches have been proposed by Kilian (2009) and Peersman and Van Robays (2008) who argue that the origins of an oil price change should be taken into account when analyzing its macroeconomic consequences. While Kilian (2009) adheres to the triangular orthogonalization, he replaces the oil price with a more exogenous variable to proxy for oil shocks by constructing a proxy for unexpected movements in global oil production. Peersman and Van Robays (2008) distinguish between oil supply and oil demand shocks by additionally including a variable for global oil production and a variable for world economic activity into the VAR model and by using the sign restrictions approach.

## 2.1 Results of the Baseline Specification

Figure 1 displays the impulse responses over the first 20 quarters after a 10 percent oil price shock, which corresponds to the estimated standard deviation of the residuals of the oil equation in the VAR model. The solid lines denote impulse responses, which are computed from the estimated VAR coefficients. The shaded areas are the 68 percent Hall percentile confidence intervals, which are constructed from a bootstrap procedure with 1000 replications (Hall, 1994). All variables are expressed in percent terms, except for the nominal short-term interest rate which is expressed in basis points at an annual rate (100 basis points equal one percent).

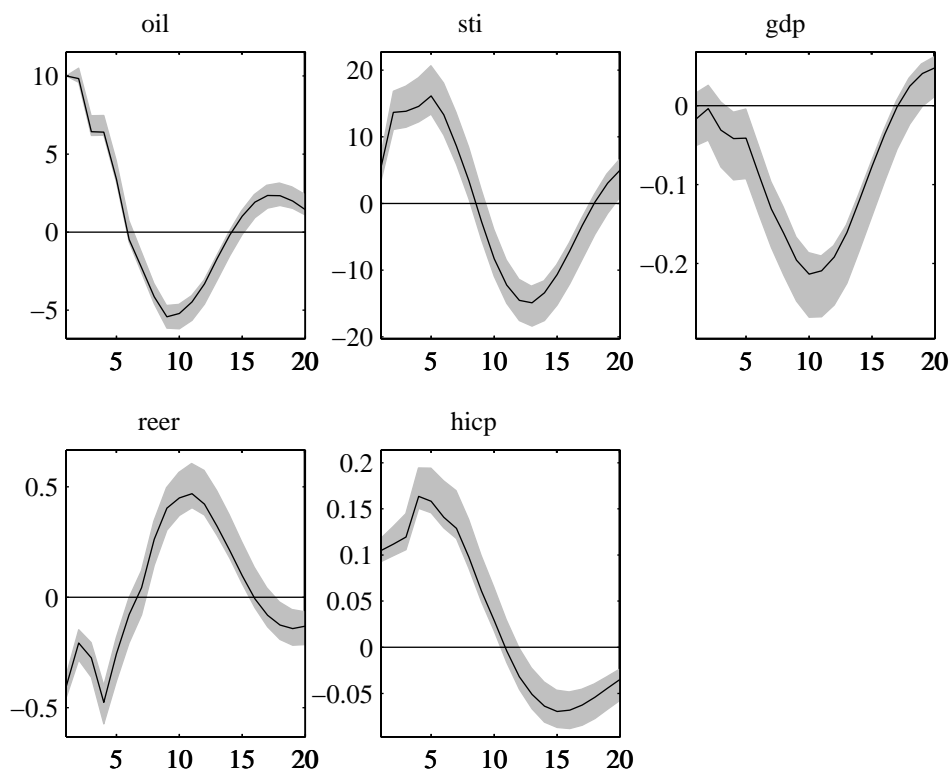
When a ten percent oil price shock hits the economy, there is an immediate increase in the general price level of roughly 0.1 percent. This is not a surprise because the oil price has a direct and instantaneous impact on the prices for heating oil and gasoline. At the same time, the short-term interest rate is shifted upwards, presumably in an attempt of the central bank to counter the inflationary impulse, and the real exchange rate devaluates. In the subsequent quarters, the price effect increases further to a maximum of 0.15 percent after four quarters before it slowly dies out. This reflects the well-known sluggishness of a wide array of consumer prices. For example, the prices for alternative energy sources like natural gas and for services like transport typically react with a delay. In addition, it may take some time, until producers pass on their cost increases to consumers. Finally, second-round effects operating through wage negotiations are implemented with some delay. Mirroring the price reaction, the short-term interest rate hike continues for some quarters. Subsequently, it is quickly taken back and reaches a trough after 12 quarters. This probably reflects the attempt of the central bank to stabilize the economy as real output starts to decline after two, and reaches a trough after ten, quarters.

## 2.2 Results of Extended Specifications

To get more insights into the transmission process after an oil price shock, we extend the VAR model with additional variables. We do this by adding only one variable at a time. This prevents an overfitting and guarantees that we do not run out of degrees of freedom. Specifically, we estimate the extended specification



Figure 1: Impulse Responses to an Oil Price Shock — Baseline Specification



*Notes:* Orthogonalized impulse responses to a 10 percent oil price shock. The solid lines denote impulse responses, which are computed from the estimated VAR coefficients. The shaded areas are the 68 percent Hall percentile confidence intervals, which are constructed from a bootstrap procedure with 1000 replications (Hall, 1994). All variables are expressed in percent terms, except for the nominal short-term interest rate which is expressed in basis points at an annual rate. The horizontal axis is in quarters.

(with the additional variable ordered last)

$$X_{i,t} = [oil_{i,t}, sti_{i,t}, gdp_{i,t}, reer_{i,t}, hicp_{i,t}, z_{i,t}], \quad (3)$$

where  $z_{i,t}$  denotes one of the following variables: the HICP component only including energy items ( $hicp_{nrg}$ ), the HICP component only including unprocessed food ( $hicp_{foodu}$ ), the HICP component only including processed food ( $hicp_{foodp}$ ), the HICP component only including non-energy industrial goods ( $hicp_{igood}$ ), the HICP component only including services ( $hicp_{serv}$ ),<sup>5</sup> the domestic producer price index of total industry (excluding construction) ( $dppi$ ), the wages and salaries component of the nominal labor cost index of sections C to K of the NACE Rev. 1 nomenclature (industry excluding construction and services excluding public administration) deflated by the HICP ( $rlci$ ), the wages and salaries component of the nominal labor cost index of total industry (excluding construction, sections C to E of the NACE Rev. 1 nomenclature) deflated by the HICP ( $rlci_{ind}$ ), and the wages and salaries component of the nominal labor cost index of services (excluding public administration, sections F to K of the NACE Rev. 1 nomenclature) deflated by the HICP ( $rlci_{serv}$ ). All series are taken from the Eurostat database and are linearly de-trended. The  $hicp$  and  $dppi$  series have been seasonally adjusted using Census X12.

The reasons for choosing these variables as additional endogenous variables in the VAR model are twofold. First, we would like to analyze the direct transmission of oil price shocks to consumer prices by focussing on the price response of energy goods, which are part of the consumption basket and which account for on average 9 percent of households' final monetary consumption expenditure. Second, with the remaining variables we would like to shed some light on the indirect transmission of oil price shocks to other components of the consumer price index. On the one hand, higher costs for energy inputs in production are likely to have an impact on producer prices, which indicate upstream pressures on the prices for non-energy goods and services. On the other hand, the response of wage costs to oil price increases is an indicator for understanding the importance of second-round effects on prices.

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<sup>5</sup>These are the five principal components of the HICP that are published by Eurostat.

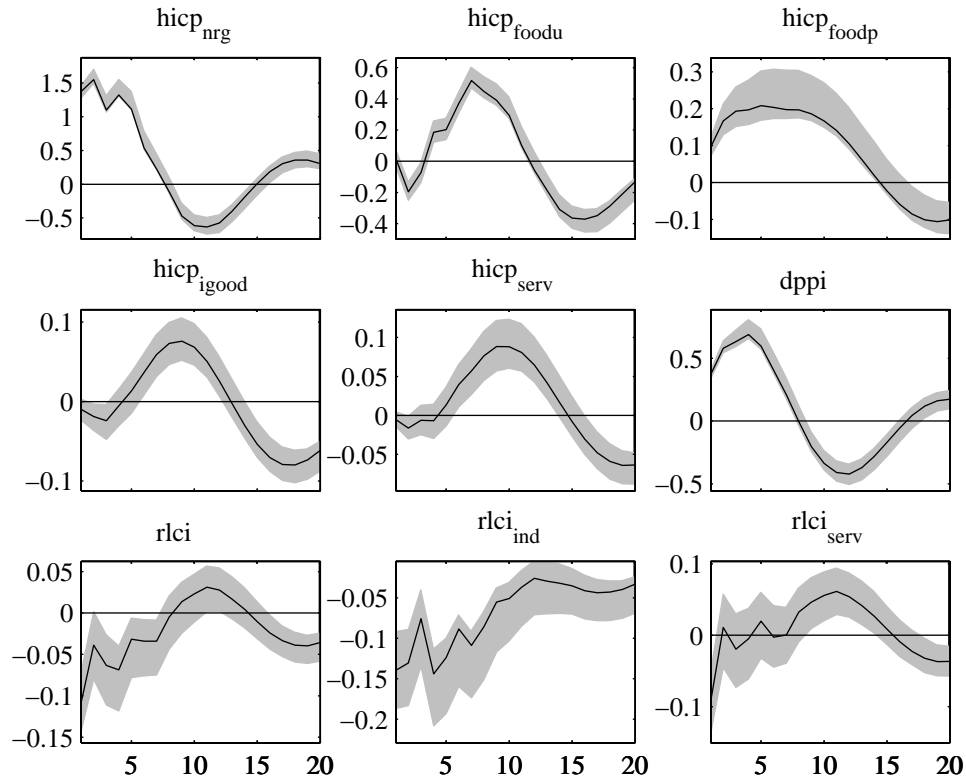
The response of each of the additional variables to an oil price shock is shown in Figure 2.<sup>6</sup> Not surprisingly, the energy component of the HICP increases instantaneously by about 1.5 percent and takes a development very similar to that of the oil price. The price of processed food also rises on impact but reaches the maximum reaction only after five quarters and remains elevated for more than ten quarters. Interestingly, the reaction of unprocessed food prices is quite different. Being unaffected on impact, they slightly decrease for two quarters before they rise considerably, reaching a maximum of 0.5 percent after 7 quarters. In contrast, the prices for industrial goods and for services show almost no reaction in the first three quarters. Subsequently, they increase significantly and peak after 8 to 9 quarters at around 0.07 and 0.09 percent, respectively. Hence, the reaction pattern of the HICP components differ markedly. In particular, the strong initial response of the total HICP index is mainly driven by the prices for energy and processed food.

Additional insights can be obtained from an analysis of producer prices and labor costs. Producer prices go up instantaneously after an oil price shock. However, they transmit with a considerable lag into the prices for industrial goods and services. This indicates that markups are temporally depressed before firms are able to raise retail prices. Total real wage costs initially drop by 0.1 percent before they start rising gradually. Given the response of the HICP, nominal wage costs seem to react with some delay. However, the patterns are different between industry and services. The negative effect on real wage costs in industry is pronounced and long-lasting, while real wage costs in services drop only on impact. They even rise above trend after about 10 quarters. Overall, real wages do not seem to be extremely sticky. In particular, they show a significant and, compared to the HICP response, quantitatively important instantaneous reaction to an oil price shock.

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<sup>6</sup>As the responses of the five baseline variables are almost unaffected by the extension of the VAR model, they are not shown again.

Figure 2: Impulse Responses to an Oil Price Shock — Extended Specification



*Notes:* Orthogonalized impulse responses to a 10 percent oil price shock. The solid lines denote impulse responses, which are computed from the estimated VAR coefficients. The shaded areas are the 68 percent Hall percentile confidence intervals, which are constructed from a bootstrap procedure with 1000 replications (Hall, 1994). All variables are expressed in percent terms. The horizontal axis is in quarters.

### 3 Heterogeneity across Countries

So far, we have estimated the panel VAR under the assumption that systematic country differences can be explained by different intercepts. However, there is considerable evidence that the euro area countries are more heterogeneous. The two most obvious reasons for heterogeneous country-specific reactions to an oil price shock are, first, the different weights of oil in both production and household consumption and, second, different levels of wage rigidity. In order to take this into account, we cluster the countries into two different groups according to the response of the overall price level to an expansionary oil price shock. Hence, the countries are divided into a *high pass-through group* and a *low pass-through group*. Since our approach is novel, we describe the methodology more explicitly.

#### 3.1 Methodology

In principle, one can think of the reaction of overall price level to an oil price shock as a general function of the country-specific characteristics. This implies that the VAR parameters depend on these characteristics and, hence, the impulse responses differ from country to country. Therefore, countrywise estimation would be optimal. Unfortunately, the precise estimation of impulse response coefficients within the VAR framework requires a relatively large number of observations. Since for the reasons outlined above our sample does not start before 1996, we need to construct country panels in order to increase the number of observations by using the cross-section dimension. To facilitate an easy distinction between such country panels, we consider only two of them, namely a *high pass-through group* and a *low pass-through group*. Hence, the question we have to answer in this section is how to allocate the countries in our sample to one of these two groups. This is achieved in three steps.

**1. Step: Define and Estimate the Distance between Sup-panels** To quantify the difference between any two sub-groups of countries, we need to define a distance measure. As we are interested in the different impulse responses

of the overall price level after an oil price shock, we use

$$d = \left| \sum_{k=q_1}^{q_2} \hat{\alpha}_{1k} - \sum_{k=q_1}^{q_2} \hat{\alpha}_{2k} \right|, \quad (4)$$

where  $\hat{\alpha}_{1k}$  and  $\hat{\alpha}_{2k}$  are the responses of the overall price level of the first and second sub-group, respectively,  $k$  periods after the occurrence of the shock, which are computed from the estimated VAR coefficients. We consider the response lags  $q_1 = 1$  to  $q_2 = 2$  (*short-run pass-through*) and  $q_1 = 3$  to  $q_2 = 12$  (*medium-run pass-through*). Hence, the distance measure in expression (4) reflects the absolute value of the difference between the cumulated impulse responses.

At first sight, it is now straightforward to allocate each country to either the *high pass-through group* or the *low pass-through group*. One can simply estimate all possible pairs of sub-groups and choose the pair with the largest distance. This approach resembles a cluster algorithm, where the number of clusters is fixed and the distance between the cluster centers (i.e., the impulse response coefficients) is maximized. However, we have to bear in mind that the impulse response coefficients are not observed but estimated. Hence, choosing the maximum distance pair only would contaminate the choice by a considerable portion of randomness. In fact, we find that there are many different pairs of sub-groups that exhibit similar distance measures.

Therefore, we proceed as follows. We estimate panel VAR models for all possible pairs of sub-groups, which contain at least three countries to ensure enough degrees of freedom for each sub-group.<sup>7</sup> Overall the number of pairs of sub-groups amounts to 957.<sup>8</sup> For all pairs of sub-groups we generate impulse responses to a standardized 10 percent oil price shock and calculate the distance measure.

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<sup>7</sup>As before the VAR models are estimated for the same set of variables as in the baseline specification (oil price, nominal short-term interest rate, real GDP, real effective exchange rate and overall price level) using a lag length of  $p = 4$ . The oil price shock is identified by imposing a triangular orthogonalization.

<sup>8</sup>Notice that in our panel the total number of disjoint pairs of sub-groups amounts to 1024 ( $= 2^{11}/2$ ). Given that we consider only pairs of sub-groups containing at least three countries, this reduces the number of pairs to 957, since there are one combination without any country, 11 combinations with only one country and 55 combinations  $-(10 \times 11)/2$  – with two countries.

## 2. Step: Select Pairs of Sub-groups with Significant Distance Measure

Then, we identify all pairs of sub-groups that exhibit a significant distance measure, where significance is detected as follows. Assume that the estimated impulse response coefficients  $\hat{\alpha}_{1k}$  and  $\hat{\alpha}_{2k}$  asymptotically follow a normal distribution. Then the sums of the coefficients considered for the distance measure, denoted by  $\hat{s}_1 = \sum_{k=q_1}^{q_2} \hat{\alpha}_{1k}$  and  $\hat{s}_2 = \sum_{k=q_1}^{q_2} \hat{\alpha}_{2k}$ , are also asymptotically normal. Under the null hypothesis that all pairs of sub-groups are identical and have the same sum of population coefficients  $s = \sum_{k=q_1}^{q_2} \alpha_k$ , the only systematic difference in the estimation results is the size of the panel from which they are estimated.

The sums of the estimated coefficients should be approximately distributed as:

$$\hat{s}_1 - s \sim N(0, \sigma^2/(N_1T)) \quad (5)$$

$$\hat{s}_2 - s \sim N(0, \sigma^2/(N_2T)), \quad (6)$$

where  $N_1$  is the size of the first sub-group,  $N_2$  is the size of the second sub-group,  $T$  is the number of observations corrected for the number of lags  $p$  in the VAR model and  $\sigma^2$  is the population variance that is assumed to be constant across countries. Furthermore, assuming that the countries are independent, we can apply a classical two-sided difference test using the statistic:  $d = \hat{s}_1 - \hat{s}_2$ . Under the null hypothesis, the statistic is approximately normally distributed with mean zero and variance:

$$\text{Var}(d) = \sigma^2/(N_1T) + \sigma^2/(N_2T) = (1/N_1 + 1/N_2) \sigma^2/T. \quad (7)$$

Since  $\sigma^2$  is unknown, we estimate the population variance from expression (7) by noting that:

$$\sigma^2 = T\text{Var}(d)/(1/N_1 + 1/N_2), \quad (8)$$

where the sample variance of the distance measure  $\text{Var}(d)$  is calculated from the numerous realizations of  $d$ . Given the estimate of  $\sigma^2$ , we construct a  $t$ -statistic and compare it with the corresponding 95 percent critical value of the  $t$ -distribution.

As a result, we have identified all those pairs of sub-groups that are significantly different from each other. If there was no significant difference at all, we would conclude that all countries show the same response of the overall price level

to an oil price shock and terminate the analysis here. However, we find 353 (266) significant distance measures for the response lags  $q_1 = 1$  to  $q_2 = 2$  ( $q_1 = 3$  to  $q_2 = 12$ ). In contrast to using only the maximum-distance pair, we thus consider all the different ways to split the panel of countries into significantly different sub-groups. Thereby, we alleviate the problem that the results could be driven by the considerable sampling error that affects the ordering of random variables. However, this approach in turn raises the question how to allocate a single country to either the *high pass-through group* or the *low pass-through group*.

**3. Step: Allocate each Country to either the High or the Low Pass-through Group** The allocation problem is tackled in the final step. Using the pairs of sub-groups with a significant distance measure we calculate the frequency that a specific country belongs to the sub-groups with the stronger reaction of the overall price level to an oil price shock. If this frequency is above a threshold that is determined below, then the respective country is allocated to the *high pass-through group*, otherwise it is allocated to the *low pass-through group*.

The idea behind this rule is as follows. Assume there are three “true” high pass-through countries. Then we should expect that the distance measure is maximized when these three countries are put into one sub-group and all the others in the other sub-group. However, due to sampling error, a different pair of sub-groups may actually exhibit the largest distance. Using our approach, we may at least expect to find each of the three high pass-through countries to be more often in the high pass-through sub-group than any of the other countries.

To accomplish this, we now derive the threshold for the frequency that a specific country belongs to the high pass-through sub-groups. From the previous step we know which pairs of sub-groups are significantly different from each other. Now we count how many times each country is in a high pass-through sub-group. A priori, each country has the same chance to be a high pass-through country. Hence, under this null hypothesis there is, for each pair of sub-groups, a 50 percent chance that a specific country is in the high pass-through sub-group. Now assume that there are a total of  $N_c$  different pairs of sub-groups of which  $n$  exhibit a significant distance measure. Then, for each country, the number of times it is in the high pass-through sub-group resembles a random experiment, where  $n$  draws



without replacement are taken from a population of size  $N_c$  that is composed of 50 percent white (=high pass-through) and 50 percent black (=low pass-through) elements. Accordingly, the frequency  $x$  – that a particular country is found to be in the *high pass-through group* – follows a hypergeometric distribution:  $f(x; N_c, N_c/2, n)$ , where the number of pairs  $N_c$  depends on the total number of countries  $M$  and the minimum size of a sub-group.<sup>9</sup>

Finally, from the hypergeometric distribution we derive a 95 percent critical value for the frequency that a particular country belongs to the *high pass-through group*. If any country is selected more often, it is unlikely that this is due to pure chance. Hence, we allocate these countries to the *high pass-through group*. All other countries are allocated to the *low pass-through group*.

### 3.2 Identified Country Groups

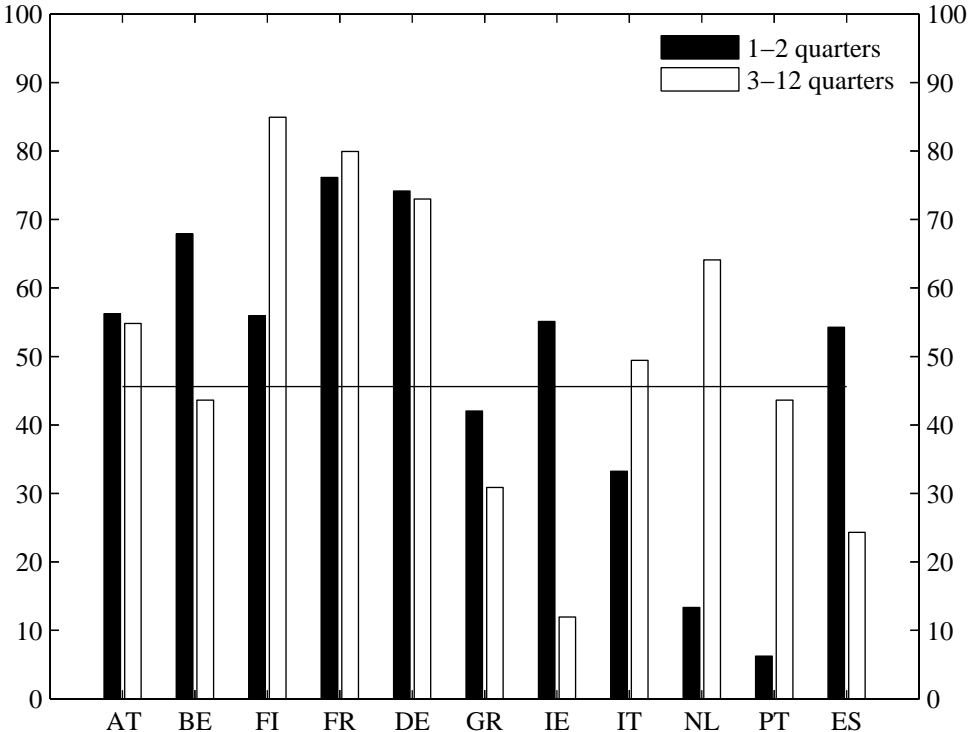
Table 1 summarizes the country clusters for the two time horizons. While some countries either belong to the group with a high pass-through (Austria, Finland, France and Germany) or a low pass-through (Greece and Portugal) in both the short run and the medium run, the other countries show either a high pass-through in the short run and a low pass-through in the medium run (Belgium, Ireland and Spain) or vice versa (Italy and the Netherlands). Figure 3 plots the relative frequencies of belonging to the high pass-through group for the two horizons together with the average critical value of the hypergeometrical distributions.

Table 1: Country Clusters

Horizon	High pass-through group	Low pass-through group
1-2 quarters	AT, BE, FI, FR, DE, IE, ES	GR, IT, NL, PT
3-12 quarters	AT, FI, FR, DE, IT, NL	BE, GR, IE, PT, ES

<sup>9</sup>Let us denote the the minimum size of a sub-group by  $m$ . Then the number of possible pairs of sub-groups can be calculated as  $N_c = \sum_{l=m}^{M-m} \binom{M}{l}$ . In our case, with  $M = 11$  countries and a minimum sub-group size of  $m = 3$ , we have  $N_c = 2048$  pairs. Of these pairs, we have to estimate only  $2048/2 = 1024$  because, e.g., the ordering of the pair  $A = \{1, 2, 3, 4, 5, 6\}$ ,  $B = \{7, 8, 9, 10, 11\}$  or  $A = \{7, 8, 9, 10, 11\}$ ,  $B = \{1, 2, 3, 4, 5, 6\}$  is irrelevant, while *ex ante* either  $A$  or  $B$  could be the strong reaction sub-group.

Figure 3: Relative frequency of belonging to the high pass-through group for different horizons following the shock



*Notes:* For each country the bars show the relative frequency in percent of belonging to the high pass-through group in the short-run and in the medium-run. The total number of combinations of countries  $n$  that show a significantly higher distance is 352 and 259, respectively. The horizontal line denotes the average critical value for  $x$  (over the two horizons) that a country is in the high pass-through group.

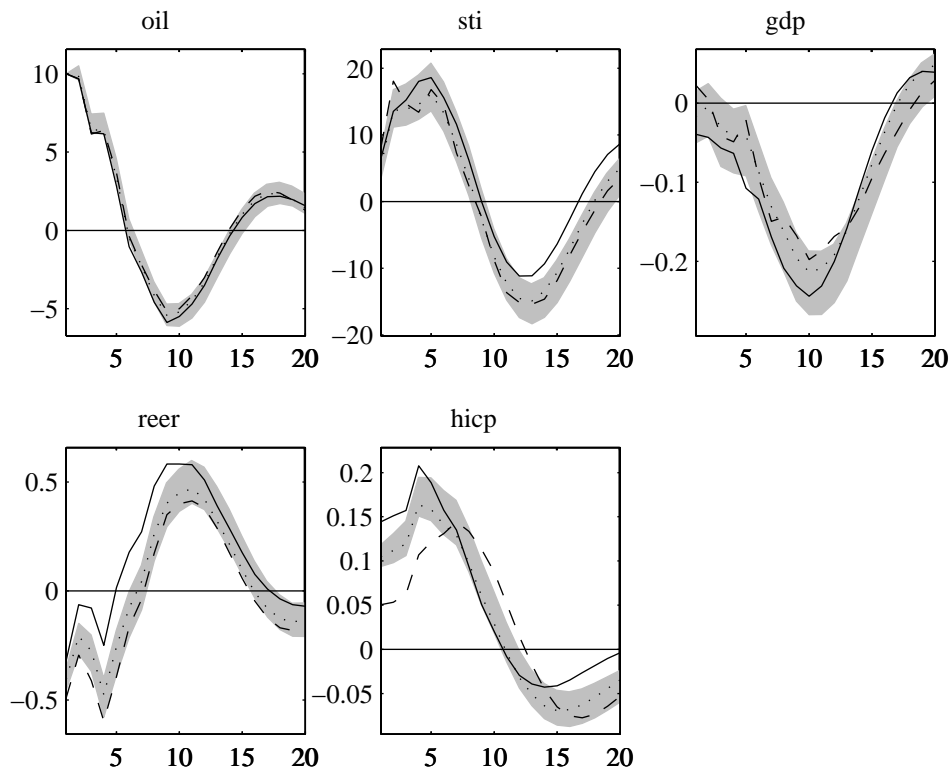
### 3.3 Impulse Responses when Countries are Clustered according to Short-run Pass-through

Next we re-estimate panel VAR models for the pair of country groups that is clustered according to the short-run pass-through of the oil price shock to the overall price level. The impulse responses are shown in Figure 4. To facilitate a comparison with the initial assumption that all countries are equal, the confidence regions for the impulse responses estimated from the baseline VAR model are reported as shaded areas.

First note that the oil price development is almost indistinguishable between the groups. This confirms that the groups are hit by an identical shock and differences in the responses of other variables are due to the structural heterogeneity between them. The most notable differences arise at the HICP responses. In the low pass-through group the HICP instantaneously rises by 0.05 percent, whereas in the high pass-through group the increase amounts to 0.15 percent. The impact reaction of both groups is outside the confidence region estimated from the baseline VAR model which confirms that there is heterogeneity. The response difference between the groups amounts to 0.10 percentage points and lasts for four quarters. In the following quarters, the reaction of the high pass-through group dies out more quickly than that of the low pass-through group. In contrast to the HICP reaction, the real exchange rate response is more pronounced in the low pass-through group. The responses of the short-term interest rate and of GDP are very similar and statistically indistinguishable. All this indicates that in the economies of the high pass-through group prices rather than real exchange rates carry the burden of adjustment while in the economies of the low pass-through group it is vice versa.

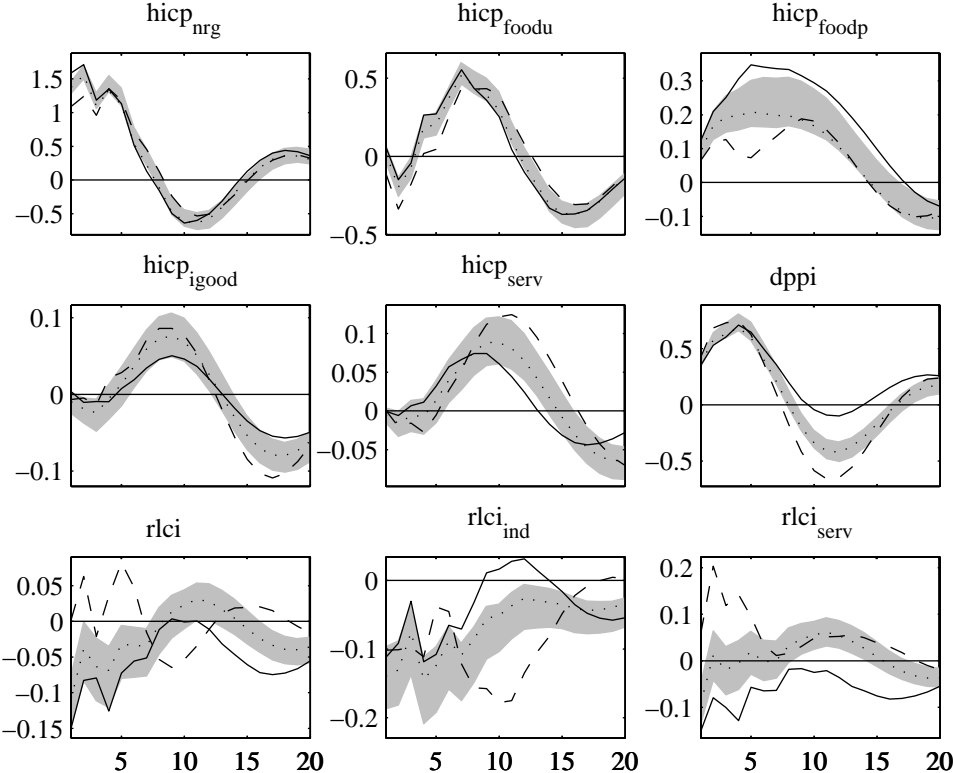
To analyze the reasons behind the differences, we report the impulse responses of the 9 variables estimated with the extended specification in Figure 5. To facilitate a comparison between the country groups, we also report the differences between the impulse responses in Figure 6. The initial difference in the response of the HICP is largely driven by the energy component of the HICP. While energy prices rise by 1.6 percent on impact in the high pass-through group, they only rise by 1.1 percent in the low pass-through group. This can largely be explained

Figure 4: Impulse Responses to an Oil Price Shock — Countries Clustered According to Short-run Pass-through



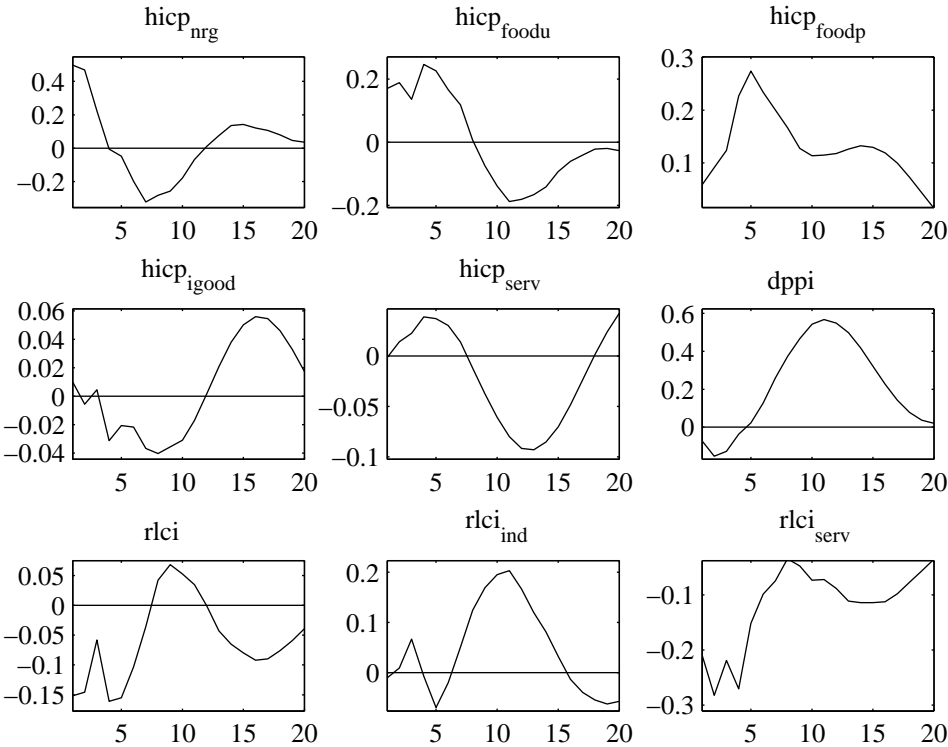
*Notes:* Orthogonalized impulse responses to an oil price shock. The lines denote impulse responses, which are computed from the estimated VAR coefficients. The dotted lines refer to the estimation of the complete panel including 11 countries of the euro area, the solid lines to the high pass-through group (AT, BE, FI, FR, DE, IE, ES), and the dashed lines to the low pass-through group (GR, IT, NL, PT). The shaded areas are the 68 percent Hall percentile confidence intervals resulting from the estimation of the complete panel. They are constructed from a bootstrap procedure with 1000 replications (Hall, 1994). All variables are expressed in percent terms, except for the nominal short-term interest rate which is expressed in basis points at an annual rate. The horizontal axis is in quarters.

Figure 5: Impulse Responses to an Oil Price Shock — Countries Clustered According to Short-run Pass-through — Extended Specifications



*Notes:* Orthogonalized impulse responses to an oil price shock. The lines denote impulse responses, which are computed from the estimated VAR coefficients. The dotted lines refer to the estimation of the complete panel including 11 countries of the euro area, the solid lines to the high pass-through group (AT, BE, FI, FR, DE, IE, ES), and the dashed lines to the low pass-through group (GR, IT, NL, PT). The shaded areas are the 68 percent Hall percentile confidence intervals resulting from the estimation of the complete panel. They are constructed from a bootstrap procedure with 1000 replications (Hall, 1994). All variables are expressed in percent terms. The horizontal axis is in quarters.

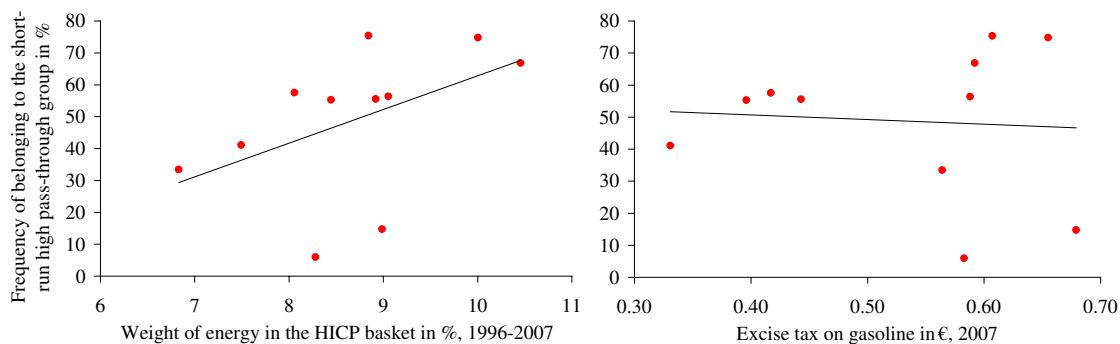
Figure 6: Impulse Response Differential between High Pass-through and Low Pass-through Group — Countries Clustered According to Short-run Pass-through



*Notes:* The difference between the impulse responses is expressed in percentage points. The horizontal axis is in quarters.

by the different weights of energy in the HICP basket. The scatter plot in Figure 7 shows that the frequency of being allocated to the high pass-through country group increases with the households' final monetary consumption expenditure for energy items. Different fuel taxes may also play a role. Since the excise is imposed as a fixed euro amount of tax per litre of gasoline, an identical percent increase in the price of gasoline net of taxes leads to a higher percent increase in the final price of gasoline in those countries where the excise tax is lower. Figure 7 confirms that there is negative relationship between the frequency of belonging to the short-run high pass-through group and the level of the gasoline tax.

Figure 7: Determinants of Price Dispersion in the Short-run



Sources: Eurostat; OECD European Environment Agency.

Among the other HICP components, the price reactions of processed and unprocessed food also contribute to a stronger overall price increase of the high pass-through group. In contrast, the prices for industrial goods and services do not react immediately. The responses of the upstream producer prices and labor costs should not play any role for HICP dispersion in the first two quarters, as their impact is typically assumed to materialize only in the medium run.

### 3.4 Impulse Responses when Countries are Clustered according to Medium-run Pass-through

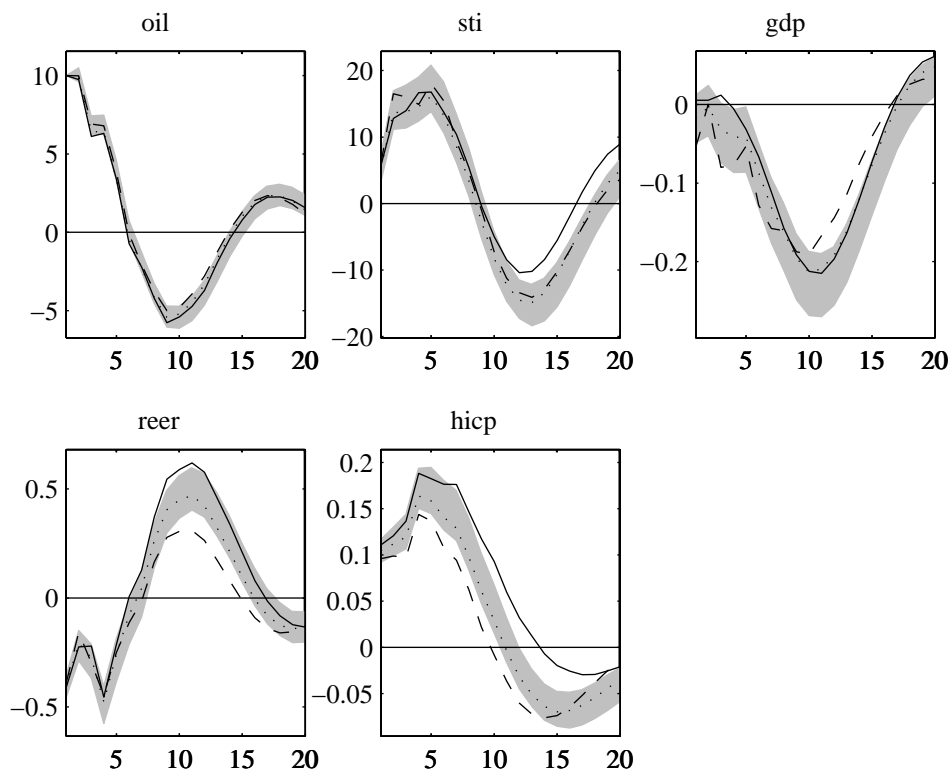
Figure 8 shows the impulse responses to an oil price shock for the two groups that are identified as the medium-run high pass-through countries (AT, FI, FR, DE, IT, NL) and low pass-through countries (BE, GR, IE, PT, ES). While the oil price development after the shock is again almost indistinguishable between groups, the HICP response is markedly different in size but not so much in the overall shape. The maximum effect in the high pass-through group is 0.18 percent as opposed to 0.13 percent in the low pass-through group. Moreover, the responses lie outside the confidence region estimated from the baseline VAR, which confirms that there is significant heterogeneity. The difference in price responses is accompanied by differences in short-term GDP responses and medium-term real exchange rate responses while the development of the interest rate is very similar across groups. In particular, the stronger slump in GDP in the low pass-through group indicates that the adjustment in this group works relatively more through the real side of the economy.

Again, a more detailed analysis is possible with the extended specification. Figures 9 and 10 show that the heterogeneous medium-run response of the HICP is mainly due to the evolution of prices for services and—to a lesser extent—for non-energy industrial goods. While the reaction of service prices reaches its peak after nine to ten quarters in both groups, the maximum effect in the high pass-through group is 0.12 percent compared to only 0.04 percent in the low pass-through group. The prices for non-energy industrial goods reach their peak one or two quarters earlier. The differential between the two groups is on average 0.04 percentage points in the second and third year following the shock.

Looking at the determinants of the consumer prices, it turns out that the producer prices react slightly stronger in the low pass-through group on impact. However, from the fourth quarter on the increase in domestic producer prices turns out to be more pronounced in the high pass-through group. While in both groups producer prices peak after four quarters, producer prices fall much faster in the low pass-through group, resulting in a maximum differential of more than 0.15 percentage points after eight quarters. The dependence on oil in relation

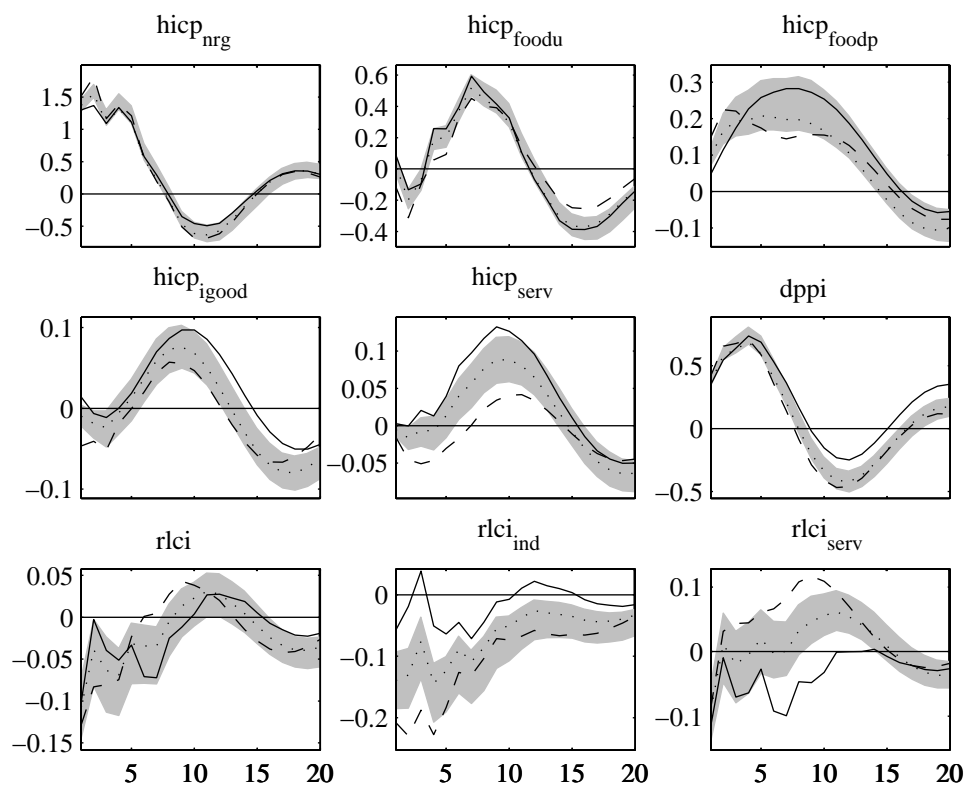


Figure 8: Impulse Responses to an Oil Price Shock — Countries Clustered According to Medium-run Pass-through



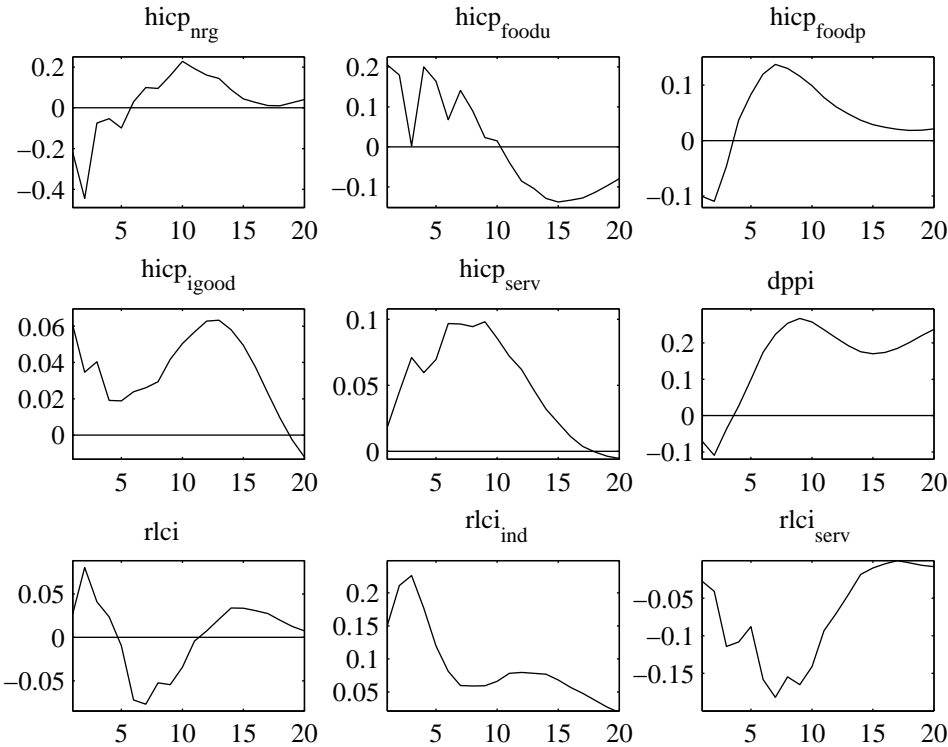
*Notes:* Orthogonalized impulse responses to an oil price shock. The lines denote impulse responses, which are computed from the estimated VAR coefficients. The dotted lines refer to the estimation of the complete panel including 11 countries of the euro area, the solid lines to the high pass-through group (AT, FI, FR, DE, IT, NL), and the dashed lines to the low pass-through group (BE, GR, IE, PT, ES). The shaded areas are the 68 percent Hall percentile confidence intervals resulting from the estimation of the complete panel. They are constructed from a bootstrap procedure with 1000 replications (Hall, 1994). All variables are expressed in percent terms, except for the nominal short-term interest rate which is expressed in basis points at an annual rate. The horizontal axis is in quarters.

Figure 9: Impulse Responses to an Oil Price Shock — Countries Clustered According to Medium-run Pass-through — Extended Specification



*Notes:* Orthogonalized impulse responses to an oil price shock. The lines denote impulse responses, which are computed from the estimated VAR coefficients. The dotted lines refer to the estimation of the complete panel including 11 countries of the euro area, the solid lines to the high pass-through group (AT, FI, FR, DE, IT, NL), and the dashed lines to the low pass-through group (BE, GR, IE, PT, ES). The shaded areas are the 68 percent Hall percentile confidence intervals resulting from the estimation of the complete panel. They are constructed from a bootstrap procedure with 1000 replications (Hall, 1994). All variables are expressed in percent terms. The horizontal axis is in quarters.

Figure 10: Impulse Response Differential between High Pass-through and Low Pass-through Group — Countries Clustered According to Medium-run Pass-through



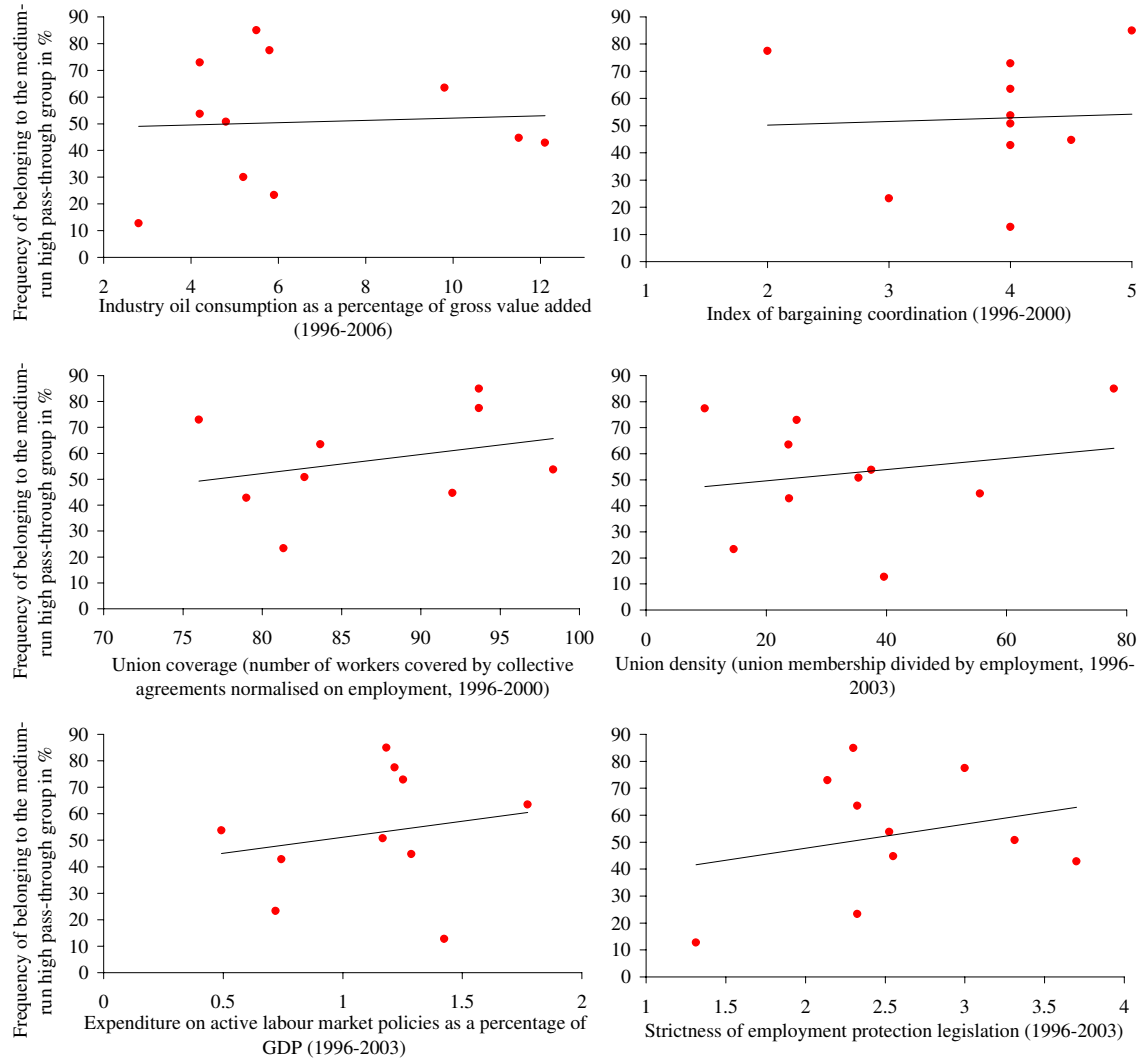
*Notes:* The difference between the impulse responses is expressed in percentage points. The horizontal axis is in quarters.

to gross value added in industrial production seems not to be the driving force behind the differential in the response of domestic producer prices across country groups and over time. While industry oil consumption varies between 3 and 12 percent of gross value added, its relationship with the frequency of belonging to the medium-run high pass-through group is only weakly positive (see the upper left scatter plot in Figure 11).

The medium-run heterogeneity is mainly caused by large differentials in the evolution of real labor costs in the industry sector. While in the high pass-through group real labor costs remain more or less unchanged in the first year following the shock, implying that nominal wages and the price level increased proportionally, real industry labor costs in the low pass-through group dropped immediately by  $-0.2$  percent and remained at this low level for around one year, before gradually returning to baseline. Thus, the countries with a higher degree of real industry wage rigidity exhibit a larger medium-run reaction of producer prices and non-energy industrial goods prices. Cross-country differences in the process of wage formation are typically attributed to differences in the wage bargaining institutions. In the euro area wage formation is to a large extent based on collective bargaining structures. However, the degrees of union coverage, union density and bargaining coordination and the extent to which the government is involved (indirectly) in the bargaining process differ widely across countries. The scatter plots in Figure 11 indicate that there is a positive relationship between the frequency of belonging to the medium-run high pass-through group and the labor market institutions.

The response of wages and salaries in the service sector, i.e. the sector which is commonly characterized as being excluded from international competition, is different from the response in the industry sector. While in both country groups real labor costs drop by approximately 0.1 percent on impact, they subsequently rise above baseline in the low pass-through group, whereas they continue to be negative for around two years in the high pass-through group. An explanation for this discrepancy between the responses of salaries and wages in the two sectors is that some of the bargaining institutions not only vary markedly across countries, but also across sectors. Du Caju et al. (2008), for example, report that in Europe trade union density is much lower in market services than in the industrial

Figure 11: Determinants of Price Dispersion in the Medium-run



Sources: OECD International Energy Agency; Nickell (2006).

Notes: The index of bargaining coordination lies within a range of [1,5] and is increasing in the degree of coordination in the bargaining process on the employers' as well as the unions' side. The strictness of employment protection legislation lies within a range of [0,5] and increases with the value depicted on the horizontal axis.

sector. However, the dispersion of real wage costs in the service sector between the two country groups does not seem to translate onto the prices of services in the consumption basket, where the pass-through of the oil price shock is significantly higher in the high pass-through group. This implies that the final price of services is not only determined by wage costs in the service sector, but also by the costs of other intermediate inputs (energy, industrial goods), which are affected more by the increase in oil prices in the high pass-through group.

## 4 Concluding Remarks

This paper studies the causes of price dispersion in the euro area emerging in response to a shock that hits all member countries symmetrically. We use a panel VAR model which is estimated over the period 1996–2007 to generate impulse responses of a range of price and wage variables to an oil price shock. To detect heterogeneities in the transmission of a structural shock in the context of a panel VAR model we suggest a data-driven approach that clusters countries into disjoint groups according to the impact of the oil price shock on the overall price level. We split our sample of countries into two groups – a *high pass-through group* and a *low pass-through group* – that are endogenously identified by using a distance measure, which is determined by the absolute value of the difference between cumulated impulse responses of the overall price level. We consider the responses of consumer prices over different simulation horizons, focusing on the oil price pass-through into national prices in the short- and the medium-run after the occurrence of the shock.

Our findings indicate that the response of consumer prices is very heterogeneous across member countries. Differences in the short-run pass-through can be attributed to the weight of energy in the consumption basket. This type of price dispersion should, however, not be a cause for concern for the ECB per se. As long as the economies are flexible enough, the adjustment of relative prices will only take a few quarters before restoring a new equilibrium.

The policy-relevant finding of this paper is that heterogeneity in the medium-run response of consumer prices is mainly due to different responses of wages and salaries in the industry sector, which is an indication of different degrees of price

and wage rigidities in the member countries and which could give rise to long-lasting distortions in relative prices after exogenous shocks. The existence of different degrees of national structural inefficiencies has important consequences for the single monetary policy in a currency union. Even if the ECB succeeds to restore price stability in the medium term, this does not guarantee that all economies operate at the efficient frontier (Dellas and Tavlas, 2005). For an inflation targeting central bank in a currency union Benigno (2004) showed that if the degrees of rigidities are different across countries, monetary policy should attach a higher weight to the country with a higher degree of rigidity.

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