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Koedijk, C.G.; Kool, C.J.M.

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Dominant interest and inflation differentials within the EMS

A reply

Kees G. Koedijk and Clemens J.M. Kool

Rijksuniversiteit Limburg, Maastricht, The Netherlands

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In their comment on Koedijk and Kool (1992), Van Poeck and Van Gompel – henceforth PG – state that we (KK) conclude that: (1) Germany in practice has not dominated the EMS, and (2) the United Kingdom always belonged to the DM-group. They disagree on both counts. Here, we will argue that PG misinterpret our conclusions and, moreover, that their cluster analysis yields results perfectly consistent with our principal component results.

For a correct comparison of the results in KK and PG, it is required to highlight the differences in methodology. PG use interest rate and inflation *levels* across countries at *discrete points in time* and analyze their bilateral distance. We (KK) use interest and inflation *differentials* between countries and analyze their (co-)variability *over time*.

Over KK's sample period 1979–1989, inflation and interest rates of the weak EMS currencies (Belgium, France and Italy) moved towards German levels. This convergence was neither very rapid, nor monotonic nor identical across countries [see figs. 1 and 2 in KK (1992)]. It formed, however, a major source of (co-)variability in interest and inflation differentials. The observed country-specific movements suggest that individual countries had some independence in choosing their inflation and interest rates and is consistent with a rejection of unilateral Germany causality. It does not prevent Germany to be a Stackelberg leader, though (see our footnote 15). It is also clear now that our finding of dominant variability between strong currencies on the one hand and weak ones on the other is perfectly consistent with PG's finding of convergence over time.

Correspondence to: Professor K.G. Koedijk, Rijksuniversiteit Limburg, P.O. Box 616, 6200 MD Maastricht, The Netherlands.

Second, we do not claim that the United Kingdom has always belonged to the Dmark-bloc. Instead, we argue that the pound's floating character enabled quick UK stabilization at any preferred inflation and interest rate level around 1983. Afterwards, the UK more or less shadowed the Dmark at higher interest and inflation levels, resulting in only very limited movements in the UK-German inflation and interest differentials (see our discussion on page 938). Again, this is consistent with PG's finding of a persistent difference between British and German inflation and interest levels over the sample.

In summary, we feel that PG, using an alternative strategy, have provided important independent evidence on convergence and leadership in the EMS, which is overall supportive of our results.