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Discussion of „A Monetary Real-Time Conditional Forecast of Euro Area Inflation“

A Monetary Real-Time Conditional Forecast of Euro Area Inflation

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Discussion

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Deutsche Bundesbank
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THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Summary

Key questions addressed in this paper:

1. Produce conditional “monetary” inflation forecasts for the euro area
2. Focus on time periods 2001/02, 2005/06, 2007/08
3. Model-based estimates of missing end-of-sample values (nowcasting)
4. Assess impact of monetary and financial scenarios on future inflation

MS-VECM

Markov-switching vector error correction model:

- Parsimonious data, "monetary" only, not based on economic stance

$$Y_t = \{r_t, R_t, \Delta m_t, \Delta p_t, yr_t\}$$

- Three lags
- Error correction: $(\Delta m - \Delta p)$ and $(R - r)$
- State indicator follows Markov process
- Model estimation via MCMC

Real-time data and forecasts

- Ragged ends
- Re-estimate model from 2001 onwards with May and November vintages
- Deviations of model-implied real M3 growth from data releases
- Conditional vs. unconditional forecasts

When is Money Growth Relevant? I

- 2001/2002: M3 growth not causing inflation pressures
- 2005/2006: Inflation pressures through estimated M3 growth. Observed number curbs those
- 2007/2008: M3 growth above average, inflation expectations still contained

Is Money Growth Really Relevant?

- Empirically, long-run relationship between money and prices seems well established

- Woodford (2007):
  - "Cashless" New Keynesian models imply a determinate rate of inflation and path for the price level
  - NK models can incorporate money-demand relation but money supply implicitly pinned down by interest-rate rule (eg Taylor rule)
  - NK models also consistent with cointegrating relation between Δm and Δp

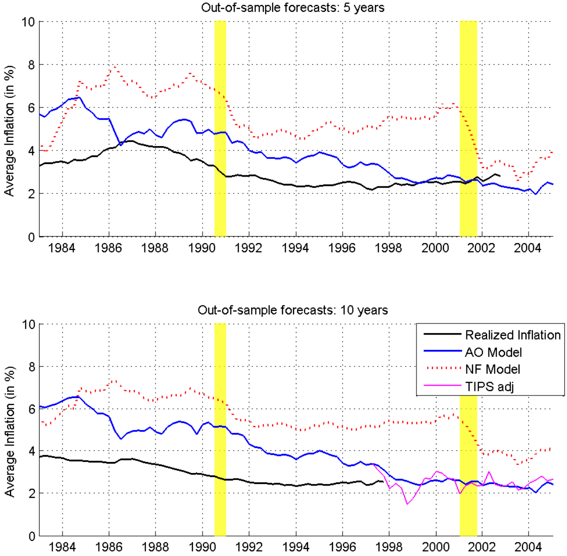
When is Money Growth Relevant? II

- Better inflation forecasts when money growth helps in identifying short-term deviations of inflation from trend
- However, if we know the trend, we are done already
- Long-run trend determined by monetary policy
- Not sure that recent history is the best predictor going forward
- Why not just use trend of inflation? How do we pin down the trend?

Alternative Cross-Check for Economic Analysis

- Friedman (1968): "...[the] economic system will work best when producers and consumers, employers and employees, can proceed with full confidence that the average level of prices will behave in a known way in the future preferably that it will be highly stable."
- Need verifiable commitment by central bank
- In rational expectations equilibrium, monetary policy should incorporate inflation expectations in order to anchor them
- Incorporate private sector inflation expectations in model directly—still just "monetary" information

Incorporating Private Sector Expectations



Chernov and Mueller (2008)

Minor comments

- Averaging of monthly values to get quarterly data
- Seasonal adjustment
- Produce unconditional forecasts and compare with other sources