

Professor Axel A Weber
President
of the Deutsche Bundesbank

The role of money in the monetary policy of the Eurosystem

Panel discussion:
ECB monetary policy: the first seven years

An ECB colloquium held in honour of Otmar Issing:
Monetary policy: a journey from theory to practice

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– Check out against delivery –

It is a great pleasure for me to participate in this colloquium to honour the work of Otmar Issing. My brief remarks will focus on the role of money in the monetary policy framework of the Eurosystem.

The appropriate role of money in monetary policy is a question to which Otmar has made an invaluable contribution not only during his tenure at the ECB but throughout his whole professional career:

- as an academic since 1960
- as a member of the German Council of Economic Experts 1988-1990
- as a member of the board of Deutsche Bundesbank and its chief economist 1990-1998
- and as board member and chief economist of the ECB since 1998

As President of the Deutsche Bundesbank I would like to take this unique opportunity to pay my tribute to Otmar- both in a personal capacity and on behalf of the institution.

The role of money in the design of monetary policy in the euro area has been one of the more criticised aspects in our monetary policy strategy.

From a theoretical point of view, the New–Keynesian approach, which forms the current paradigm in monetary economics, by and large doubts the relevance of money to monetary policy making in an environment in which central banks predominantly use a short-term interest rate to achieve their goals.

In addition, though from a theoretical less radical point of view, market participants often criticise that the contribution of the monetary analysis to the decision-making process of the Governing Council is not as obvious as it should be.

I will argue in my following remarks that both criticisms are unjustified in view of the challenging task of conducting monetary policy in real time in an uncertain environment.

First of all, there is a general consensus that “inflation is a monetary phenomenon” – as Milton Friedman put it; a central bank that aims at price stability therefore simply cannot afford to completely discard monetary indicators; and what I learn from more recent deliberations of central banks that traditionally have a more critical attitude towards the use of monetary indicators – such as e.g. the Bank of England – confirms my assessment.

However, how exactly monetary analysis is implemented and how it is used for monetary policy decisions depends crucially on the empirical relationship between monetary aggregates, inflation and other macroeconomic variables of interest.

The question can be put in simple terms: How monetarist should one be? And my simple and agnostic answer is: as monetarist as the empirical evidence supports.

There is a well-established long-run relationship between money growth and inflation in the euro area: monetary aggregates in the euro area prove to have explanatory power for longer-term inflationary developments. This is documented, not least, by current research carried out in the Bundesbank.

As long as these relationships hold, there are convincing empirical reasons for paying close attention to monetary developments in the policy making process.

Beyond this issue, there are further conceptual reasons why money should matter: It offers a suitable longer term perspective for internal decision-making and external communication, and thus enhances credibility. Of course, this latter point is of general importance for central banks but it has been especially important for the Eurosystem and its monetary policy at the beginning of the third stage of EMU. In 1999 the Eurosystem did not possess its own established track record. Thus, a strategy making use of the empirically established long-term relationship between money growth and inflation was especially important to gain and secure credibility right from the outset of EMU.

And all this is irrespective of questions as to whether there is an active role for money to play in the transmission mechanism, i.e. whether money is exogenous or endogenous.

This brings me back to the more academic criticism that stems from the New-Keynesian school of thought. Despite all the undoubted merits of such an approach – sound theoretical principles, microfoundations, general equilibrium character – it also has its shortcomings.

Firstly, the transmission mechanism is specified too leanly and mechanistically.

For example, one prominent channel for the role of money in this class of models is a real-balance effect – something that is empirically difficult to verify and arguably too simplistic in the present-day world of financial markets.

Some years ago, in the controversy between monetarists and Keynesians Allan Meltzer argued that: "The difference between the Keynesians and us is less in the nature of the process than in the range of assets considered". Applied to the current environment, those words have not lost much relevance.

Furthermore, the New-Keynesian approach is a natural extension of the real business cycle framework to a world with nominal rigidities. As such, it focuses on short-term deviations of the relevant variables from trend. The empirical evidence for the correlation between money and inflation, however, is of a low-frequency nature. In other words, it is more relevant to the trend behaviour of inflation.

In a nutshell, given the empirical evidence, it seems that the New-Keynesian framework is missing something important in the working-mechanisms of the economy and the inflation generating processes that govern it. Something that is— at least - empirically captured by the information content of monetary aggregates.

Moreover, the merits of analysing monetary developments in a broad framework encompassing credit dynamics allows to extract valuable information with regard to possible financial market tensions caused by the build-up of asset price bubbles.

In the light of these considerations it is not so much a question of whether monetary policy in the Eurosystem should pay close attention to monetary aggregates. The more relevant issue is how this should best be done, that is, how monetary aggregates should feature in the monetary policy design.

Here, the challenging task for monetary analysis is how to separate in real time the noise in the short-run development of monetary aggregates from the part of monetary dynamics that signals risks to future price stability.

Monetary analysis, properly understood and implemented, can not be a mechanical forecasting exercise. It has to take into account the possibilities of money demand shocks injecting noise into the liquidity-inflation nexus or possible structural shifts in money demand relations.

Up-to-date monetary analysis should be a broadly-based approach and an ongoing intellectual endeavour. And this is precisely how monetary analysis has developed over the past few years in the Eurosystem. In an environment of high financial uncertainty it has identified large liquidity shocks which led to significant portfolio shifts in liquid and secure bank deposits. And it has derived a toolbox of liquidity measures signalling possible excess liquidity.

Applying this toolbox has allowed to separate liquidity developments rooted predominantly in financial uncertainties from developments signalling more imminent inflation risks. For example the actual strong increase in the money stock M3 which is accompanied by very low level of interest rates and a strong rise in loans to the private sector.

All in all, an elaborate analysis of monetary aggregates as well as their components and counterparts is a useful tool for monetary policymakers. It has clearly the potential to enhance the robustness of our judgments about future economic developments. In the past few years, academic research has emphasised the advantages of robust analytical tools for appropriate policy responses in an environment of prevailing uncertainty – something that has always been known by practitioners of central banking.

However, besides this longer-term nature of the relationship between monetary developments and inflation, there is the need to take into account also other and more short-term risks to price stability. This is the core of the economic analysis in the strategy of the Eurosystem.

Given the different time horizons of the economic and monetary analysis I think that the demands that are sometimes brought-up in the public debate to merge the two pillars are not convincing. There is no existing model that would allow to integrate the multitude of economic information that is relevant for monetary policy in one coherent theoretical structure. This is especially relevant for the integration of monetary aggregates into traditional macroeconomic and macroeconometric models. Insofar, proposals to merge the two pillars are ill-founded. The ultimate goal of the two-pillar structure is the efficient utilisation of available information for monetary policy decisions and communication. However, one possible approach with regard to the information gained through the lens of the economic and monetary analysis might be found in a stronger formalised combined assessment of the information included in both pillars for future inflation developments. This is in a sense what the cross-checking is all about. Of course, the merits of a more formalised forecasting combination would have to be weighted against any possible loss of information that might be associated with it.

This brings me to another criticism that is sometimes voiced, namely that monetary developments are not regarded as being informative about the Eurosystem's monetary policy decisions. In my view, this criticism is unjustified:

Firstly, the very nature of the information content of the monetary analysis has to take into account its role as a cross-checking device and its focus on longer-term risks to price stability.

Secondly, in an environment of heightened financial market uncertainty actual monetary dynamics may to a large part be driven by noise which does not necessitate a monetary policy reaction. The portfolio-shift adjustment of money growth in the post 2001 period can be seen as an example.

By the way: The role of money in our policy decisions has been analysed in recent empirical research; on that issue which found a kind of non-linear relationship between monetary developments and policy reaction. Such threshold effects in my view deserve further empirical investigation.

Let me conclude by saying that the experience of the first seven years of EMU has shown:

- that the monetary analysis plays an important role in our policy strategy and our policy decisions
- that the monetary analysis is a challenging and evolving exercise given today's financial market dynamics
- but that, even in such an environment, money has an empirically justified informative role.

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