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## *Current Issues Briefing*

**The Monetary Pillar at the  
E.C.B.**

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# Three views on the use of the monetary pillar at the ECB

Paul Mizen and Gert Peersman, November 2008

There is little doubt that correlations between monetary growth and inflation point to a long run relationship. In his article 'No Money, No Inflation' Mervyn King uses a series of charts to point out that the correlation between money growth and CPI inflation is positive for any time horizon and any conventional definition of money using UK data (pp. 64-67 in Mizen (ed) 2001). McCandless and Weber (1995) makes a similar point for US data and the finding is supported for many other countries. Indeed Nelson (2003) points out that there was a consensus in the early 1990s that inflation was a monetary phenomenon. However, in recent years New Keynesian models (Woodford, 2006), have greatly downplayed the role of monetary aggregates, and money has taken on a passive role in their models of monetary transmission. Michael Woodford has gone further than this in their downgrading of monetary information. Woodford's (2006) critique delivered to the European Central Bank has five points that suggest monetary information is unnecessary. He argues that we do not need a money variable to learn the lessons about inflation from the 1960s and 1970s. What we know about inflation and inflation control through independent central banks with inflation targets can be derived from a model in which there is no role for money, (although the model is consistent with a passive money demand function). Any information from monetary trends he argues is the same as information from inflation trends (money growth and inflation are cointegrated) and there is nothing to suggest that monetary growth is necessary or the best means to predict inflation. Where monetary information is used to cross check inflation trends to allow a central bank to determine the inflation path and set appropriate policy, Woodford claims the cross checks may not be robust.

Gerlach (2004) interprets the two pillars as separate approaches to forecast inflation at different time horizons or frequency bands. Under this view, the monetary pillar is seen as a way to predict inflation at long time horizons and to account for gradual changes in the steady-state rate of inflation over time. This view has largely been accepted by the ECB in its explanation of its own procedures. In its defence the ECB has also pointed out that the beneficial aspect of monitoring monetary developments goes well beyond the prediction of future inflation but rather lies in the fact that they might provide early information on emerging financial imbalances if asset price bubbles are indeed the result of strong and

persistent growth in money and credit aggregates.

Three pieces of research have been conducted by CFCM research fellows in the centre on this issue.

Katrin Assenmacher-Wesche and Stefan Gerlach (2007) have written in 'Understanding Euro Area Inflation at High and Low Frequencies' that money growth and inflation are closely tied in the long run or, as they suggest, at low frequencies so that other factors determine inflation at higher frequencies or in the short run. Assenmacher-Wesche and Gerlach hypothesise that money growth plays a causal role for inflation at low frequencies and the output gap a causal role for inflation at higher frequencies.

Assenmacher-Wesche and Gerlach (2007) use frequency-domain methods to explore the hypothesis that the two pillars, the monetary and economic analysis, contain information useful for understanding inflation in the euro area at different time horizons. They first use frequency-domain techniques to obtain estimates of potential output and the output gap, and to deseasonalise inflation. Next, they apply the band spectrum regression approach pioneered by Robert Engle and later extended by Peter Phillips for non-stationary time series to estimate reduced-form inflation equations. This approach allows the filtering and estimation to be performed jointly. Finally, they investigate the patterns of (predictive) causality between inflation, money growth and the output gap at different frequencies. They argue this is a natural way to formalise the ECB's view that inflation is determined by money growth in the long run, and demonstrate that it is compatible with euro-area data.

In two closely related approaches monetary considerations have been re-introduced into models used for policymaking by appealing to the information from the well established quantity theory. The first approach by Benati (2005) and Pill and Rautananen (2006) establishes that there is a strong empirical relationship between the filtered low frequency components of inflation and money growth, which suggests evidence of money growth can be informative about future inflation. A second approach, advocated by Lucas (2006) and implemented by Beck and Wieland (2007, 2008) has established that monetary cross-checking can correct inflation trends that may be distorted by large and persistent misperceptions. Nelson (2003) points out that a direct link is not a necessary condition to support the view that inflation is a monetary phenomenon, but the growing emphasis that monetary information assists in conducting policy suggests that monetary data have an informational role to play by providing *additional information* about inflation.

In a second paper on 'The Predictive Role of Money for Monetary Policy Decisions: Evidence from the UK and the Euroarea' Thanset Chevapatrakul, Tae-Hwan Kim, and Paul Mizen use a modified New Keynesian framework to consider the relevant information for predicting the directional change of interest rates. When monetary information is added to an information set containing measures of inflation, the output gap and the most recent change to the interest rate, there is improvement in the prediction of the direction change in interest rates using a probit method. These findings show that for euroarea and UK data sets and for a wide range of alternative indicators, monetary information improves the prediction of directional change. The result is found for a range of alternative model specifications suggesting that the finding is robust.

This result adds to a growing literature that shows a role for monetary indicators. Various approaches that extract the core monetary trend using time series filtering techniques find the core measure as a monetary indicator predicts inflation even allowing for the impact of other explanatory variables (including Assenmacher-Wesche and Gerlach, 2007, Beck and Wieland, 2007, 2008).

The contribution of this paper goes beyond exploring the relationship between money growth and inflation, although this is clearly underpinning this result, and provides evidence that money helps predict the direction of change of interest rates set by committees of policymakers. When we consider the degree of improvement in prediction it is comparable to that of other information variables, a result that suggests that there cannot necessarily be assigned a 'special' role for money over and above other variables on empirical grounds alone, but like Assenmacher-Wesche and Gerlach these authors argue that the importance of monetary information should not be overlooked, and the current move to re-introduce money into New Keynesian frameworks is a welcome step.

A third paper by Christiane Baumeister, Eveline Durinck and Gert Peersman on 'Liquidity, Inflation and Asset Prices in a Time-Varying Framework for the Euro Area' argues, in contrast with the previous two papers, that there are doubts about the usefulness of the second pillar linking money growth and inflation. These doubts have arisen from the fact that money has been steadily drifting away from its reference value in recent times whereas, until very recently, inflation has remained low, stable and close to target. Another source of concern about this strategy is that the growth of monetary aggregates is viewed at times as an important indicator of price instability, while at others substantial movements in broad money are largely ignored because they are associated with special

factors such as portfolio shifts into or out of broad money. The unequal treatment and the changing information content of monetary developments suggest that the link between excess money growth and future inflation has not been constant over time and that the effects of shifts in money might depend on the prevailing economic conditions as well as the the origin of increased liquidity. The objective of their paper is to address the importance of the monetary pillar by distinguishing between the different sources of increased liquidity, explicitly modeling the time-varying relationship between money, economic activity, asset prices and inflation, and investigating to what extent the accompanying state of the economy helps explain the changing impact of excess liquidity shocks.

Their research provides evidence that the underlying source of increased liquidity is crucial for determining the repercussions on the wider economy. More specifically, when the rise in liquidity originates in M1, the impact on economic activity and asset prices is very strong and the ultimate pass-through to inflation is proportional. In contrast, a shock to M3-M1 has only minor economic consequences and the pass-through to inflation is limited resulting in a permanent rise of real money holdings.

They find considerable variation in the dynamic responses over time. The inflationary consequences of a liquidity shock turn out to be much weaker since the mid-eighties resulting in a more permanent shift of real money. With regard to the effect on output and asset prices, they observe an increased responsiveness during some periods but more muted reactions at other points in time. It is conceivable that these time-varying patterns of macroeconomic effects following liquidity shocks depend on the state of the economy, e.g. asset price boom-busts, credit booms, the business cycle, the process of financial liberalization or the monetary policy stance.

By performing additional estimations where the dynamic responses are dependent upon the macroeconomic conditions at the time of the shock, they find support for the fact that the impact of a liquidity shock on economic activity becomes stronger when the economy is characterized by an extreme state of asset prices, during a credit boom, when a recession is looming and when monetary policy is restrictive. On the other hand, inflationary effects are larger during asset price and credit booms. They also find evidence that effects of liquidity shocks on asset prices are much stronger in booms and busts of asset price cycles, when the business cycle is in an expansion and during a credit boom.

These papers offer a broad range of views on the usefulness of monetary information as a guide for the ECB in conducting monetary analysis in combination with the economic

analysis.

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Issue Brief #6: War Games Redux. Issue Brief #5: Conventional Arms Control in Europe. Issue Brief #4: U.S.-Russian Nuclear Security Cooperation. Issue Brief #3: Saving the INF Treaty. Issue Brief #2: Prospects of West-Russia Security Dialogue. The current round of talks is different from the past, however, because of the dismantlement of the existing arms control architecture. Russia and the United States will soon find themselves in a situation where almost no area of military competition is regulated. Briefing refers to what instructions, guidance and warnings you receive before going out on a Mission. Debriefing refers to the process of receiving your Report and narration of experiences, explanations for deviations from brief, including the re... Answered 3 years ago · Author has 7K answers and 3.2M answer views. As I understand it (and I'm no expert in this), a "briefing" is any information by one person to someone in authority, generally in short ("brief") form. This Current Issues Brief examines these issues and looks at local and international calls for greater Federal Government involvement in urban transport issues. (18 pages). BACK to Index What's New. Victorian Election 2002 [HTML][PDF 9,224KB] Current Issues Brief No. 13 2002-03 Scott Bennett, Politics and Public Administration Group Gerard Newman, Statistics Group 10 February 2003. Briefings, debriefings and handovers are a critical component of the communication process and critical to information flow during an emergency event. Briefings ensure all personnel involved, including contractors, understand the objectives, strategies, safety issues, roles and responsibilities and reporting relationships. Handovers are briefings at a changeover of personnel in the same role. current activity Identify suggested mechanisms to resolve those issues Provides shared situation awareness. Our issue briefs provide additional details on topics identified as most important by our stakeholders. View all the issue briefs on the Reporting Library for a comprehensive overview or choose an issue in the drop-down menu. To learn about current and future employee skills development, visit our Building Digital Skills issue brief. Compensation & Benefits 8 8 Benefits and policies vary by country and operating company. AT&T works hard to attract and retain talented, diverse and engaged employees.