Otmar Issing and the Monetary Pillar

By C.A.E. Goodhart

About a fortnight ago, Otmar himself sent me a (signed) copy of his joint book, based on the Stone lectures in Economics, entitled 'Imperfect Knowledge and Monetary Policy'. In this, the first of the two lectures was presented by Otmar, with the assistance of Oreste Tristani. In this lecture, once again, Otmar sets out his reasons for paying close attention to the path of the monetary aggregates.

His position on this has certainly not been without challenge or contention. Not only economics in general, but even more so macro-economics and Central Banking in particular, are subject to fashion. Monetarism, in any of its guises, has become somewhat unfashionable; and the neo-Keynesian three equation synthesis, based on a forward-looking I/S curve, Phillips curve and reaction function, rides high. The econometric models are based on so-called micro-founded, rational expectations DSGE models. Deviate from this, and you are not a member of the In Crowd.

And yet we know far less about the working of our economies than we may like to think, especially when our priors get supported by computer assisted data-mining. In this context of fundamental uncertainty, it is necessary in Otmar's view, and I quote, to maintain "a firm reliance on the fundamental and robust results of monetary economics", which in turn requires "a clearly defined price stability objective and a strong focus on medium- and long-term outcomes, rather than the optimization of

short-term trade-offs", (p. 22). That obviously gives a potentially starring role to the monetary pillar, since to quote "the long-run link between inflation and money growth is a virtually undisputed result in monetary theory", (pp 68-69).

But, beyond the dictates of fashion, there is another more practical problem facing those, like me and Otmar, wishing to preserve a major informational role for the monetary aggregates. This is that it has been, in my view correctly, decided that the main function of a central bank is to set short-term interest rates; and this latter is inherently a relatively short-term decision, not only because a new decision will supersede the latest within a month, or so, but also because the attempt to peer forward into the uncertain future beyond a year, or two, is so fraught with uncertainty as to be hardly worth the effort. But in this relatively near-term context the short-run vagaries of velocity have meant that monetary developments have had comparatively much less predictive value than the so-called real forecasts. As Otmar admits (p. 69), "short-term developments of money can be subject to a number of large and persistent (velocity) shocks which blur the long-run link."

Indeed, and despite an embarrassingly large number of econometric studies which had suggested that the demand for money function of the euro would be even more stable than that of its previous constituents, (I quote), "Money growth has had a bumpy ride over the first years of EMU", (p. 69). See Figure 1, which I have taken from Manfred Neumann's EMU Monitor Outlook of November 2005. As is apparent from that chart, broad money growth began to surge in 2000/1, just at the same time as real output growth declined sharply (Figure 2). There were a whole slew of 'special factors', notably related to an enhanced desire for liquidity in the context of asset

market volatility, which Otmar amongst others has recorded, and this first monetary overshoot played, as far as an outsider can tell, little, or no, role in the Governing Council's overall interest rate decisions. Even so, as Otmar reports, "these results confirm that it is difficult to extract information on future price developments from short-run movements in monetary growth", (p. 71).

Of course, Otmar goes on "to reaffirm…. the existence of a trend relationship between money and prices", but quite how does one incorporate such essentially long-run considerations into what is, I would contend, a comparatively quite short-run-focussed decision process?

And yet, let me review more recent conjunctural developments. A few months ago most of the received wisdom in forecasting circles was that 2006 would see a period of slowing growth and declining inflation. The consumer of last resort in the USA was borrowing to do so against his housing equity, and that would slow down, as it would also in the UK, Spain, and elsewhere. China's excess supply of both saving and tradeable goods would keep the lid on prices and costs world-wide. Against that there was evidence of strongly expansionary monetary developments in the eurozone, and more widely across the world. One key feature was that, in the previous monetary upsurge in the eurozone, broad money and bank lending to the private sector had been moving in opposite directions. Now they are moving in concert, and strongly upwards, (Figure 3).

My reading of the tea-leaves is that in this latest battle between negative, so-called real factors, and the positive, expansionary effects of the monetary aggregates, the

latter have been winning, on points at least, and that economic expansion in 2006, throughout most of the world, is looking stronger, as the days go by.

One conclusion that I draw is that, whereas monetary developments do have informational value, trying to interpret what that may be is often complex and requires attention to detail, notably sectoral detail. Moreover the links between purely monetary and real developments depend on frictions and imperfections on the real side. Such imperfections are, in my view, likely to be more prominent in respect to bank borrowing than to bank deposits, so my own preference would be to give relatively more weight to bank credit, and less to M3 on its own, in assessing the height of the monetary pillar.

It would, however, be deeply ironic if the timing of Otmar Issing's departure from the ECB Board was to coincide closely with a demonstration of the underlying value of the monetary pillar, but that may be just what is happening.