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The ECB's Curious *Money Fixation*

BY WOLFGANG MÜNCHAU

The latest on Europe's campaign to cement monetary growth to monetary policy.

Possibly the most important development in the European macroeconomic policy debate over the last year has been the return of money as a subject of polite conversion among economists. We are not talking about a return to 1970s-style monetarism, although a minority of participants in this debate do. This is a debate about whether central banks have gone too far in downplaying the significance of monetary aggregates in practical monetary policy making.

Larry Meyer, a former member of the Board of Governors of the Federal Reserve, famously said that "money plays no role in today's consensus macro model, and it plays virtually no role in the conduct of monetary policy, at least in the United States." Money, however, does play a much more central role at the European Central Bank, and it appears that its role has recently been getting stronger, contrary to what had been predicted when the ECB started up in 1999.

The issue came up during a research conference organized by the ECB in Frankfurt in November 2006. The ECB invited Professor Michael Woodford from

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“A model of monetary policy that includes no role for money is incomplete.”

—ECB President **Jean-Claude Trichet**

Columbia University, who made a strong case for the superiority of the New Keynesian models, in which money has no separate role. It is not clear why the ECB held this conference in the first place. It is possible that this was merely an honest and open invitation to the academic community to challenge the ECB’s own thinking. What is astonishing, however, is that the ECB did not put up anybody to refute Woodford’s powerful critique on academic grounds—although a number of qualified academics would have happily complied. Instead it wheeled out past and present central bankers who presented well-known policy arguments in defense of the ECB’s present strategy—such as the ECB’s inherited credibility and the always-repeated mantra that inflation is ultimately a monetary phenomenon. Most observers walked away with the impression that the anti-money camp had won by a technical knock-out. Without becoming too conspiratorial, one wonders whether this outcome might have been intentional. The debate about the role of money, it appears, is also raging in the hallways of the ECB itself.

There may be a consensus within the ECB that money carries important information, but there are important nuances. For example, this is what Jean-Claude Trichet, president of the ECB, wrote in the *Financial Times* on November 8, 2006:

> Do not mistake me for a monetary Luddite: I have immense appreciation for the intellectual elegance and sophistication of modern monetary policy models that leave no room for money. In many respects, I fully agree with their implications regarding the benefits of price stability, the crucial importance of central bank credibility, the advantages of pursuing a clear and predictable policy, and the centrality of private inflation expectations. Yet, I cannot dispel my doubts that a model of monetary policy that includes no role for money is incomplete in some important respects.

I recall a conversation with Trichet in 1998, when he was governor of the Bank of France, during which he expressed skepticism about M3 as a reliable indicator for future French consumer price inflation. I would describe Trichet’s current stance as content with a strategy that gives him a maximum degree of discretion, leaving him as the only person in a position to explain it. But he is not a monetarist.

Now compare Trichet’s relatively moderate position with that of Jürgen Stark, who succeeded Otmar Issing as a member of the ECB’s governing board in 2006. Prior to his appointment, Stark was regarded as a die-hard monetarist, very much in the tradition of Issing. If you thought Stark had moderated his views in any way since taking up his position, you could not be more wrong. Here is what he had to say on this subject, in an article in *Frankfurter Allgemeine Zeitung* on December 14 (my translation from German):

“At their heart, these [New Keynesian] models simplify the role of money and of the financial system to such an extent that it cannot be acceptable for decision makers in monetary policy.”

—Chief economist and ECB governing board member **Jürgen Stark**

> At their heart, these [New Keynesian] models simplify the role of money and of the financial system to such an extent that it cannot be acceptable for decision makers in monetary policy. This is why I have fundamental doubts as to whether such models—even if they are conceptually elegant and stimulating—constitute a practical aid to monetary policy.

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"The extent of [money's] relevance in practice can only be judged on the basis of available evidence."

—ECB Vice President
Lucas Papademos

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This is an extraordinary comment coming from a member of the ECB's executive board. Stark dismisses the usefulness of the New Keynesian models, which are after all the foundation of the ECB's first strategic pillar—the economic pillar. While Trichet has, in his own words, "immense appreciation for the intellectual elegance and sophistication of modern monetary policy models," Stark says that they "cannot be acceptable for decision makers in monetary policy." Stark not only makes a strong case for a monetary pillar. He makes an even stronger case against the economic pillar.

ECB watching is like playing a game of Now-You-See-Me-Now-You-Don't.

In a subsequent speech at the University of Frankfurt, where he explained the ECB's monetary policy in greater detail, he presented a relatively skeptical assessment of the first pillar, calling it "important but not all-encompassing," in contrast to the monetary pillar which he called "prominent" with no further qualifying adjective attached.

A more nuanced view is that of ECB Vice President Lucas Papademos. This is what he had to say at the conference:

> One…limiting assumption [of the New Keynesian models] is that real money balances do not affect aggregate demand directly. Another is that financial intermediation, which is important for credit provision and liquidity creation, has no effects on economic activity… It is, of course, legitimate to ask whether these additional refinements that I am suggesting will turn out to be quantitatively significant. My expectation…is that they are likely to be important. But the extent of their relevance in practice can only be judged on the basis of the available evidence.

Papademos is effectively saying: Yes, money matters, but unlike Stark he keeps an open mind on this issue, pending further empirical evidence.

What has been the evidence so far? During the last eight years, there were two periods of above-average M3 growth in the euro area. The ECB ignored the first (2001–03), when it took the judgement that the monetary expansion was caused by portfolio shifts, and had otherwise no economic effects. But it did not ignore the latter (since end 2005), when high M3 growth coincided with strong growth in private credit.

When debating the future role of money, it is important to distinguish between two fundamentally separate questions: First, should money play any role in modern monetary policy at all? Serious academics like Woodford would not hesitate a second before answering no. Most central bankers in Europe and a minority of academics would answer the first question with yes. The second question is whether monetary analysis should constitute its own separate policy pillar alongside economic analysis, as it does at the ECB. There is overall consensus, among academics, that the answer to that question should be no.

The most pertinent criticism of the two-pillar strategy is that it lacks transparency. How do you weigh the two pillars? How do you bring the information together? Which pillar do you follow if monetary and economic analyses contradict each other, as they do at the moment? Looking at the ECB from the outside, there is no clear-cut way to see which pillar the ECB will jump on at any

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given moment. ECB watching is like playing a game of Now-You-See-Me-Now-You-Don't.

At the point of writing—mid-December 2006—the pillar-one forecasts suggest that present policy is broadly consistent with price stability. The pillar-two analysis, however, postulates that monetary policy should be tighter. Both pillars cannot be simultaneously right.

So we are approaching crunch-time for the ECB's two-pillar strategy. If the present reliance on monetary analysis were to lead to an excessively tight policy—a non-trivial possibility in view of the risks of a U.S. slowdown, or a collapse in the dollar—then the case for a separate monetary pillar would weaken. In this case, pressure will grow to fold pillar two into pillar one. Obviously, the opposite could happen in the—unlikely—event that the present policy stance proves to be too loose.

I am not sure that academics like Woodford and others could ever persuade the ECB to drop money. In any case, the real problem with the ECB's strategy is not that they take money seriously. I would also agree that a central bank should not dispose of money entirely. The problem is a money-based second pillar, which at best gives rise to confusion, and at worst leads to bad policy judgments in the future. ◆

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Embodied in many of the terrorist prophecies is the desire by the scaremongers to further government growth. The 9/11 attack produced immediate demands for a federal employees to replace private screeners at airports. Two months after the attack, Representative Maxine Waters (D-CA) accused those who would not immediately agree "to federalize those screeners" of "playing with people's lives." Senator Robert Byrd (D-WV) said: "Only by federalizing screeners can the American public be assured that cost-cutting will not occur to the detriment of their safety."

But the Government Accountability Office last year reported that private screeners do a better job of detecting dangerous objects than the 45,000-employee, much-criticized Transportation Security Agency. Naturally, the scaremongers have not demanded a privatization of the screening process in the interests of safety.

The most terrifying recent false prophecy had nothing to do with economics or terrorism and was issued in October by a Russian astronomer. As reported by *Pravda* on October 10: "According to the Russian astronomer Nikolai Fedorovsky, a giant comet flying at top speed is bound for Earth. Should the comet stay on the collision course, it may hit the planet in late October. The impact will cause devastating tsunamis, earthquakes, and avalanches, says Fedorovsky. He saw the killer comet in a telescope two weeks ago. He managed to calculate the comet's trajectory."

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But if you are alive and reading this, it means that October has come and gone without the arrival of the killer comet. Mr. Fedorovsky's desire to warn the world and gain attention for himself, has proven useless. Perhaps the fears spread by Buffett, Peterson, et al., should be similarly ignored. ◆