



ECB Observer

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*Analyses of the monetary policy of
the System of European Central Banks*

Money matters for inflation in the euro area

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SUMMARY

PART 1

ECB independence and price stability

The success of the stability oriented monetary policy of the ECB depends on the acceptance of the bank's *institutional set-up*. In this context, the ECB's political independence seems to be of the utmost importance. However, important pillars for safeguarding the bank's political independence – such as, for instance, governments' adherence to the European Stability and Growth Pact and the acceptance of the *division of labor* between fiscal and monetary policy – have been repeatedly called into question. For instance, *calls for a better dialog* between fiscal and monetary policy may sound well-intentioned at first glance. At second glance, however, there should be little doubt that such a cooperation, if put into practice, would run the risk of undermining the political independence of the ECB, thereby posing a risk to the stability of the euro. That said, the ECB is well advised to continue to reject proposals for a *better policy mix*. – Ongoing and improved explanation of the advantages of having an independent central bank is needed to keep alive public support for the current institutional monetary arrangement in the euro area.

PART 2

Monetary policy and structural reforms

What role does monetary policy play for structural reform in open economies? Empirical estimations were performed with panel data for 23 OECD countries from 1970 to 2000. Structural reform was measured by the Economic Freedom of the World index, whereas the monetary policy constraints were measured by a monetary commitment index and the prevailing exchange rate regime. – Our results provide little evidence for the hypothesis that a discretionary monetary policy promotes structural reform and economic freedom. The results strongly argue against those views maintaining that a business cycle oriented and lax monetary policy has never and nowhere been detrimental for employment. In fact, our results show that discretionary monetary policies tend to lead to a lower degree of structural labor market reform and, hence, to lower employment. That said, the ECB should pursue a medium- to long-term oriented monetary policy if it wants to strengthen growth and employment in the euro area via supporting reforms.

PART 3

A critical view of the real interest rate concept

The concept of the *neutral (real) interest rate* (NRIR) – as implied by the *Taylor rule* – recommends monetary policy to set real interest rates at a level that closes, or at least smoothes, the output gap. We argue that such a policy, if put into practice, would entail substantial pitfalls. First, monetary policy is an inadequate tool for influencing real GDP: the central bank's impact on long-term interest rates and GDP is actually small (or not existing); to make things

worse, a cyclically oriented policy would provoke the well-known *time-lag problem*. Second, and perhaps most importantly, the NRIR concept is not necessarily compatible with price stability, as it ignores the impact of credit and money growth on inflation. – As a result, we are in favour of a long-term oriented monetary policy that has a strong focus on money and credit growth and asset prices. Such a monetary policy would not only be compatible with the objective of price stability. It would also reduce the risk of the economy falling into (a monetary induced) financial crisis which, in turn, could have a highly negative impact on output and employment.

PART 4

ECB monetary policy and euro inflation outlook

Even at a main refinancing rate of 3.25%, ECB monetary policy remains very expansionary. We forecast annual HICP inflation in 2007 to be 2.3% on average (including the German VAT hike). Due to strong excess liquidity, annual consumer price inflation is likely to remain at 2.3% in 2008. We recommend raising ECB rates further to around 4.0%, for reducing credit and money supply growth, thereby dampening inflationary pressure. – Our money demand analyses for the euro area suggest that, in recent years, *excess liquidity* might have been translating in great part into *asset price inflation* rather than consumer price inflation. The results indicate that headline M3 growth is actually much more closely related to the *ongoing loss of purchasing of money power of the euro* – that is consumer and asset price inflation – than may be widely believed. That said, for keeping inflation in check it seems advisable for the ECB to set interest rates in line with the signals provided by (trend) money supply (excess liquidity).



Zusammenfassung

TEIL 1

Herausforderungen für die Unabhängigkeit der EZB

Der Erfolg der stabilitätsorientierten EZB-Geldpolitik hängt entscheidend von der Einhaltung der *institutionellen Spielregeln* ab. Hierzu zählt insbesondere die Wahrung der politischen Unabhängigkeit der EZB. In jüngster Zeit sind jedoch ihre Grundlagen – Befolgen des Stabilitätspaktes, Akzeptieren der Eigenständigkeit der Geldpolitik und des EZB-Auftrages durch die Regierungen etc. – immer wieder in Frage gestellt worden. Vor allem wohlklingende *politische Umarmungsversuche* in Form der Forderungen, die EZB-Politik müsse besser mit der Finanz- und Wirtschaftspolitik koordiniert werden, entpuppen sich bei genauem Hinsehen als Versuche, den Unabhängigkeitsstatus der EZB zu unterwandern. Soll die Unabhängigkeit der EZB gewahrt bleiben, müssen Forderungen nach einem stärkeren Dialog nicht nur strikt zurückgewiesen werden. Vielmehr ist auch eine fortwährende öffentliche Aufklärung nötig, um den Konsens für die Unabhängigkeit der Notenbanken zu wahren und damit die Aussicht auf stabiles Geld zu verbessern.

TEIL 2

Geldpolitik und Strukturreformen

Welche Rolle spielt die Geldpolitik für Strukturreformen? Um diese Frage zu beantworten, wurden Daten aus 23 OECD-Ländern für die Zeit 1970 bis 2000 untersucht. Der Effekt von Strukturreformen wurde dabei anhand des *Economic Freedom of the World Index* operationalisiert, die Geldpolitik anhand eines geldpolitischen Regelbindungsindex und dem herrschenden Wechselkursregime. Die Ergebnisse der Untersuchung sprechen gegen die häufig geäußerte Meinung, dass eine laxe, konjunkturorientierte Geldpolitik einen positiven Beitrag zu Strukturreformen leistet (Bestätigung der *TINA-Hypothese*). Als Handlungsempfehlung lässt sich für die EZB-Geldpolitik ableiten, dass sie weiterhin eine mittel- bis langfristig orientierte Geldpolitik verfolgen sollte, wenn es gilt, Strukturreformen u. a. auf den Arbeitsmärkten – und damit letztlich Wachstum und Beschäftigung im Euroraum – zu unterstützen; eine konjunkturorientierte Politik wäre kontraproduktiv.

TEIL 3

Ein kritischer Blick auf das Konzept des „neutralen Zinses“

Eine Geldpolitik auf Basis des (*realen*) *neutralen Zinses* oder *Taylor Zinses* – wie derzeit in Fachkreisen vielfach propagiert – bringt viele Probleme mit sich. Erstens ist der neutrale Zins eine gänzlich unbekannte Größe, deren Schätzung erhebliche, wenn nicht gar unüberwindbare Schwierigkeiten bereitet. Zweitens werden die Möglichkeiten einer Konjunktursteuerung durch die Geldpolitik, auf die das neutrale Zinskonzept setzt, überschätzt. Drittens wird die *Time-Lag-Problematik* übersehen. Viertens ignoriert eine solche Poli-

tik, dass die Kredit- und Geldmengenexpansion langfristig entscheidende Größen für das Preisniveau darstellt. So könnte ein Notenbankzins, der dem neutralen entspricht, dennoch zu Inflation führen. – Wir favorisieren daher eine langfristig ausgerichtete EZB-Geldpolitik, die viel stärker als bisher das Zusammenspiel von Kreditexpansion, Asset-Preis-Entwicklung und Geldmengenwachstum betrachtet. Solch eine Politik würde nicht nur im Einklang mit Preisniveaustabilität stehen, sondern auch die Gefahr von Finanzkrisen, die zu schweren Wachstumskrisen werden können, abmildern.

TEIL 4

EZB-Geldpolitik – Rück- und Ausblick

Die Geldpolitik der EZB ist auch nach den jüngsten Zinsanhebungen auf 3,25% immer noch außergewöhnlich expansiv. Die Inflation der Konsumentenpreise dürfte trotz des Ölpreisverfalls 2007 (einschließlich des deutschen Mehrwertsteuereffekts) bei 2,3% liegen und wegen des starken Geldmengenwachstums auch in 2008 bei 2,3% verharren. Wir empfehlen, den EZB-Zins weiter anzuheben, um das übermäßige Wachstum der Kredit- und Geldmengen und damit den Inflationsdruck einzudämmen. Dies dürfte einen EZB-Leitzins von ungefähr 4,0% erforderlich machen. – Unsere Analysen zur Geldnachfrage im Euroraum deuten darauf hin, dass die *Überschussliquidität* sich weniger in Konsumentenpreisen als vielmehr in Vermögenspreisen zu entladen scheint (*Asset Price Inflation*). Die Befunde deuten an, dass der Zusammenhang zwischen Geldmengenwachstum und *tatsächlicher* Geldentwertungsrates enger zu sein scheint, als vielfach angenommen wird. Soll also der Geldwertschwund verhindert werden, d. h. Konsumenten- als auch Vermögenspreis-inflation, muss sich die EZB mit ihrer Zinspolitik viel enger an den Geldmengensignalen orientieren als sie es bisher getan hat.



APPENDIX

A.3 – ECB Observer – recent publications

Number	Title and content	Date of publication
No. 9	Money matters for inflation in the euro area Content: 1. <i>Challenges to ECB independence.</i> – 2. <i>A critical review of the “neutral interest rate” concept.</i> – 3. <i>Monetary policy and its impact on structural economic developments.</i> – 4. <i>ECB policy – review and outlook.</i>	29 November 2006
No. 8	Back to the rules Content: 1. <i>Rules for sound money.</i> – 2. <i>How the ECB and the US Fed set interest rates.</i> – 3. <i>A call for ECB Governing Council minutes.</i> – 4. <i>Euro area monetary policy and inflation outlook.</i>	27 September 2005
No. 7	Towards a “more neutral” monetary policy Content: 1. <i>A critical look at ECB staff inflation projections.</i> – 2. <i>Asset price inflation – a cause of concern for monetary policy.</i> – 3. <i>Impact of short-term rates on stock market returns.</i> – 4. <i>ECB rate and euro inflation outlook.</i>	16 September 2004
No. 6	Liquidity on the rise Content: 1. <i>A case against ECB FX market interventions.</i> – 2. <i>“Price gaps” and US inflation.</i> – 3. <i>“Price gaps” and euro area inflation.</i> – 4. <i>ECB rate and euro inflation outlook.</i>	2 February 2004
No. 5	Challenges to ECB credibility Content: 1. <i>Fundamentals of ECB credibility.</i> – 2. <i>ECB strategy review – increasing the bank's open flank.</i> – 3. <i>Uncertainty – pressure for easier monetary policy.</i> – 4. <i>ECB policy review and outlook.</i>	8 July 2003
No. 4	International coordination of monetary policies – challenges, concepts and consequences Content: 1. <i>International coordination of monetary policies.</i> – 2. <i>Does the ECB follow the Fed?</i> – 3. <i>Stock prices – a special challenge for monetary policy.</i> – 4. <i>ECB monetary policy review and outlook.</i>	19 December 2002
No. 3	The Fed and the ECB – why and how policies differ Content: 1. <i>The US Federal Reserve System and the European System of Central Banks – selected issues under review.</i> – 2. <i>The reaction functions of the US Fed and ECB.</i> – 3. <i>The influence of monetary policy on consumer prices.</i> – 4. <i>ECB rate policy and euro area inflation perspectives.</i>	24 June 2002
No. 2	Can the ECB do more for growth? Content: 1. <i>Should the ECB assign a greater role to growth?</i> – 2. <i>Government finances and ECB policy – a discussion of the European Stability and Growth Pact.</i> – 3. <i>“Price gap” versus reference value concept.</i> – 4. <i>Assessment of current ECB policy and outlook.</i>	19 November 2001
No. 1	Inflationsperspektiven im Euro-Raum Content: 1. <i>Warum die EZB-Geldpolitik glaubwürdig ist.</i> – 2. <i>EZB-Strategie – Stabilitätsgarant oder überkommenes Regelwerk?</i> – 3. <i>Stabilitätsrisiken der Osterweiterung.</i> – 4. <i>Zinspolitik der EZB in 2001 und 2002.</i>	17 April 2001

APPENDIX

A.4. – ECB Observer – objectives and approach

The objective of ECB Observer is to analyse and comment on the conceptual and operational monetary policy of the European System of Central Banks (ESCB). ECB Observer analyses focus on the potential consequences of past and current monetary policy actions for the future real and monetary environment in the euro area. The analyses aim to take into account insights from monetary policy theory, institutional economics and capital market theory and are supplemented by quantitative methods. The results of the analyses are made public to a broad audience with the aim of strengthening and improving interest in and understanding of ECB monetary policy. ECB publishes its analyses in written form on a semi-annual basis.

APPENDIX

A.5. – ECB Observer *team members*

Professor Dr. *Ansgar Belke*, born 28 March 1965. 1991 Diploma in Economics, University of Münster; 1995 Ph.D. in Economics, University of Bochum; 1997 Research Fellow at the Center for Economic Research, Tilburg/Netherlands, Visitor at the Centre for European Policy Studies, Brussels; 2000 Habilitation in Economics and Econometrics, University of Bochum; 2000 Visiting professor (C4) at the University of Essen, 2000 Full Professor of Economics, University of Vienna (C4); since 2001: Full Professor of Economics (C4), Head of 'Research Center for European Integration', and board member 'Eastern Europe Center', University of Hohenheim; since 2004: Research Fellow at the Institute for the Study of Labour (IZA), Bonn. Fields of interest: International Macroeconomics, Monetary Economics, European Integration, Venture Capital Finance. Publications in journals such as *North American Journal of Economics and Finance*, *Open Economies Review*, *Public Choice*, *Scottish Journal of Political Economy*, *World Economy*. Referee for journals like *European Economic Review*, *Open Economies Review*, *Public Choice*, and for the German Science Foundation, Volkswagen Foundation, German Economic Association, FEMISE Network (Forum Euro-Mediterranéen des Instituts Economiques). Presentations at international conferences such as 'Annual Econometric Society European Meeting', 'European Economic Association Congress', 'International Seminar on Macroeconomics (EEA and NBER)'. E-mail: belke@uni-hohenheim.de.



Professor Dr. *Martin Leschke*, born on 2 March 1962 in Oberhausen, Germany. From 1983 to 1989 studied economics at the Westfälische Wilhelms-University. From 1989 to 1993 assistant to professorship for economics, specialising in monetary economics (professor Dr. Manfred Borchert). Dissertation in 1993 at the University of Münster. 1994 research fellowship at the Center for Study of Public Choice, George Mason University, Fairfax, VA, USA (sponsored by DFG). Habilitation in 1998. From 1999 to February 2002 assistant professor at the University of Münster. Since March 2002, professorship of economics at the University of Bayreuth. Research focus: money theory and monetary policy, European integration, institutional economics, macro-economic issues. E-mail: martin.leschke@uni-bayreuth.de.



Professor Dr. *Wim Koesters*, born on 26 November 1942 in Greven, Germany. From 1963 to 1968 studied economics at the Westfälische Wilhelms-Universität Münster. From 1968 to 1969 stipendium at the Florida State University and Harvard University. From 1969 to 1982 assistant to Prof. Dr. Hans K. Schneider in Münster and Cologne. Dissertation in 1972 at the University in Münster. Habilitation in 1982 at the Universität in Cologne. From 1982 to 1991 Professor of macroeconomics at the University of Münster. Since 1991 professorship in theoretical economics I (Jean Monnet professorship) at the Ruhr-University Bochum. Memberships: Council for Economic and Social Policy – Verein für Socialpolitik, Working Group International Economic Relations and Working Council German Domestic Market of the List Association, Working Group Economic Policy and Development, Working Group Europe Policy and Science of the Konrad Adenauer-Stiftung, Brussels Initiative, Latin America Centre of the University of Münster (corresponding), Presidium of the Working Group European Integration, European Community Studies Association/USA. Research focus: monetary theory and monetary policy, macro-economics and stabilisation policy, labour market theory and policy, integration theory and policy with a special emphasis on monetary integration, international trade policy. E-mail: wim.koesters@ruhr-uni-bochum.de.



Dr. *Thorsten Polleit*, born 4 December 1967 in Münster, Germany. From 1988 to 1993 studied economics at the Westfälische Wilhelms-Universität Münster. 1995 dissertation with Professor Dr. Manfred Borchert, professorship for monetary economics, specialising in monetary theory and policy. From 1997 to March 1998 ABN AMRO (Deutschland) AG, Frankfurt, Institutional Investor Equity Advisory. From April 1998 to September 2000 Chief Economist (Germany) at ABN AMRO (Deutschland) AG and ABN AMRO Asset Management GmbH. Since October 2000 at Barclays Capital in the Economics and Strategy Division. Since the end of 2002, he is a member of the *Handelsblatt / Wall Street Journal Europe* sponsored ECB Shadow Council. Thorsten is active in the fields of financial market and monetary policy theory research. In March 2003, he was appointed Honorary Professor at the HfB – Business School for Finance and Management, Frankfurt, lecturing Monetary and Financial Market Economics. Research focus: monetary theory and policy, and capital market theory. E-mail: thorsten.polleit@barcap.com.