Comments on “In Search of Monetary Stability: the Evolution of Monetary Policy” by Otmar Issing*

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June 2008

*****Presented at the Seven BIS Annual Conference, *Whither Monetary Policy? Monetary Policy Challenges in the Decade Ahead*, Luzern, June 26-27, 2008.

Issues

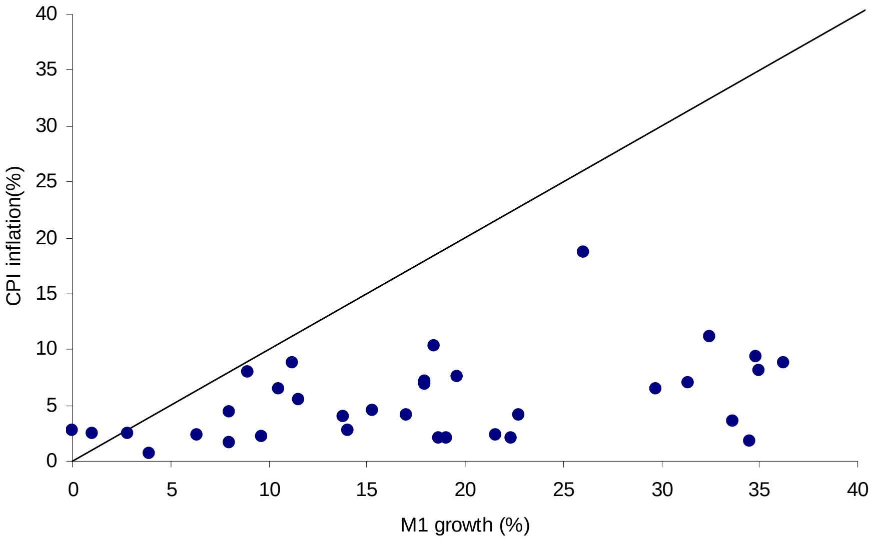
1. Introduction: causality, neutrality and monetary policy strategy
2. Money in an inflation target regime
3. Financial stability and bubbles
4. Concluding remarks

1. Introduction

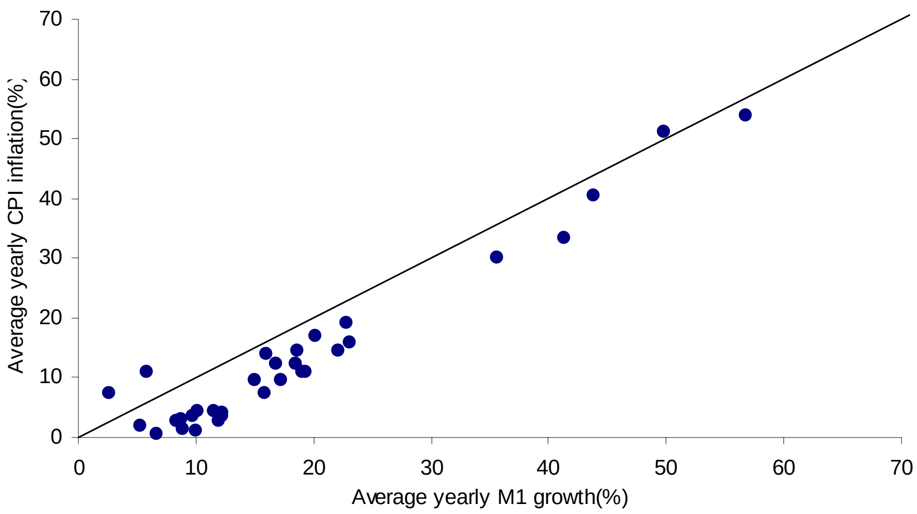
- *Inflation is always and everywhere a monetary phenomenon* (Friedman, 1963).
- **(1) Causality vs. (2) neutrality**
- From (1) *k*-rule: long-term price stability with short and medium term monetary stability (Friedman, 1960).
- (2) is fully consistent with using the interest rate as the instrument for monetary policy, without violating monetary neutrality. However, there is no causal relationship from money to inflation.

M1 growth and inflation

2007



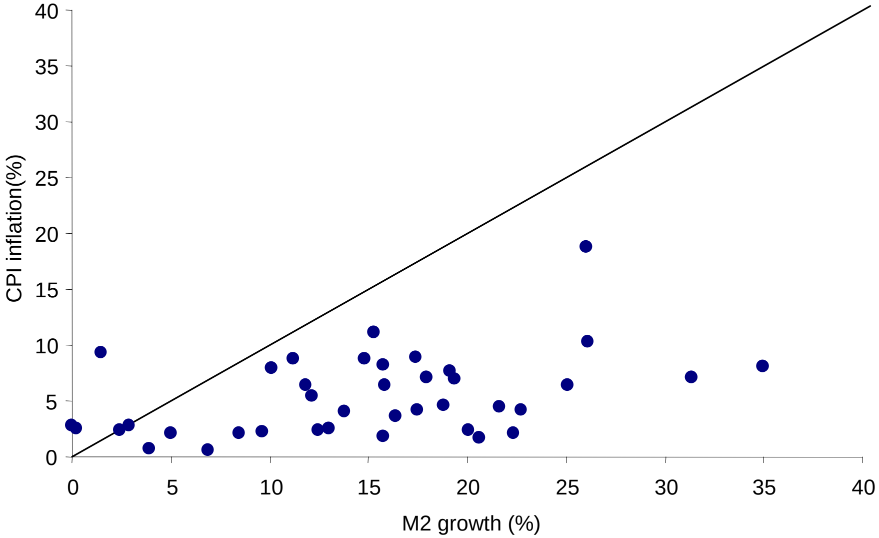
Average 1984-2007



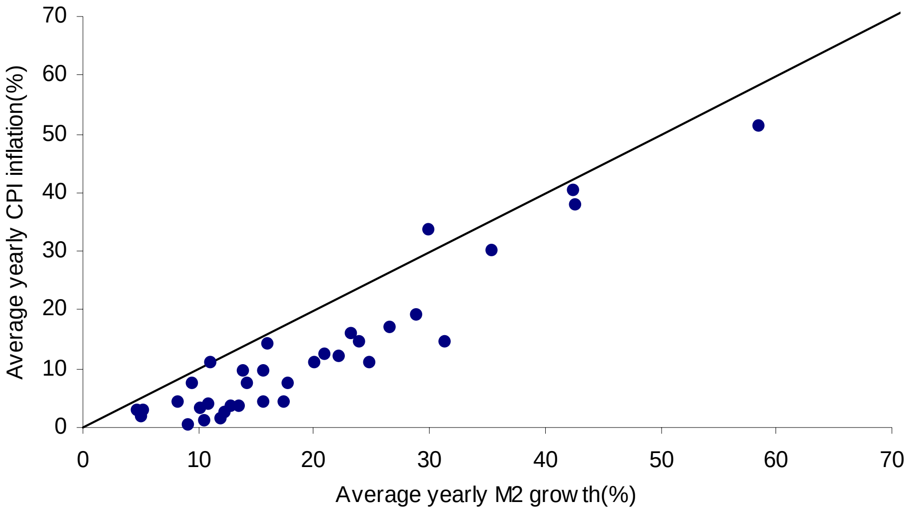
Source: IFS, IMF.
Countries included are 50 that have complete data records.

M2 growth and inflation

2007



Average 1984-2007



Source: IFS, IMF.
Countries included are 50 that have complete data records.

1. Introduction

- Must differentiate between:
  - **Objectives:** monetary, financial, output, or price stability.
  - **Strategies:** inflation, monetary aggregates, nominal income targeting. Or a combination (example, escape clauses).
  - **Instruments:** interest rates, money, etc.
  - **Information:** indicators to adjust instruments.
- But two strategies (similar to two instruments), and one objective is unclear (Kilponen and Leitemo, 2006).
- There is a need to separate between strategies and indicators, which I think is in the spirit of current theoretical developments and in the spirit of this paper and the two-pillars.

2. Money and Inflation Targets

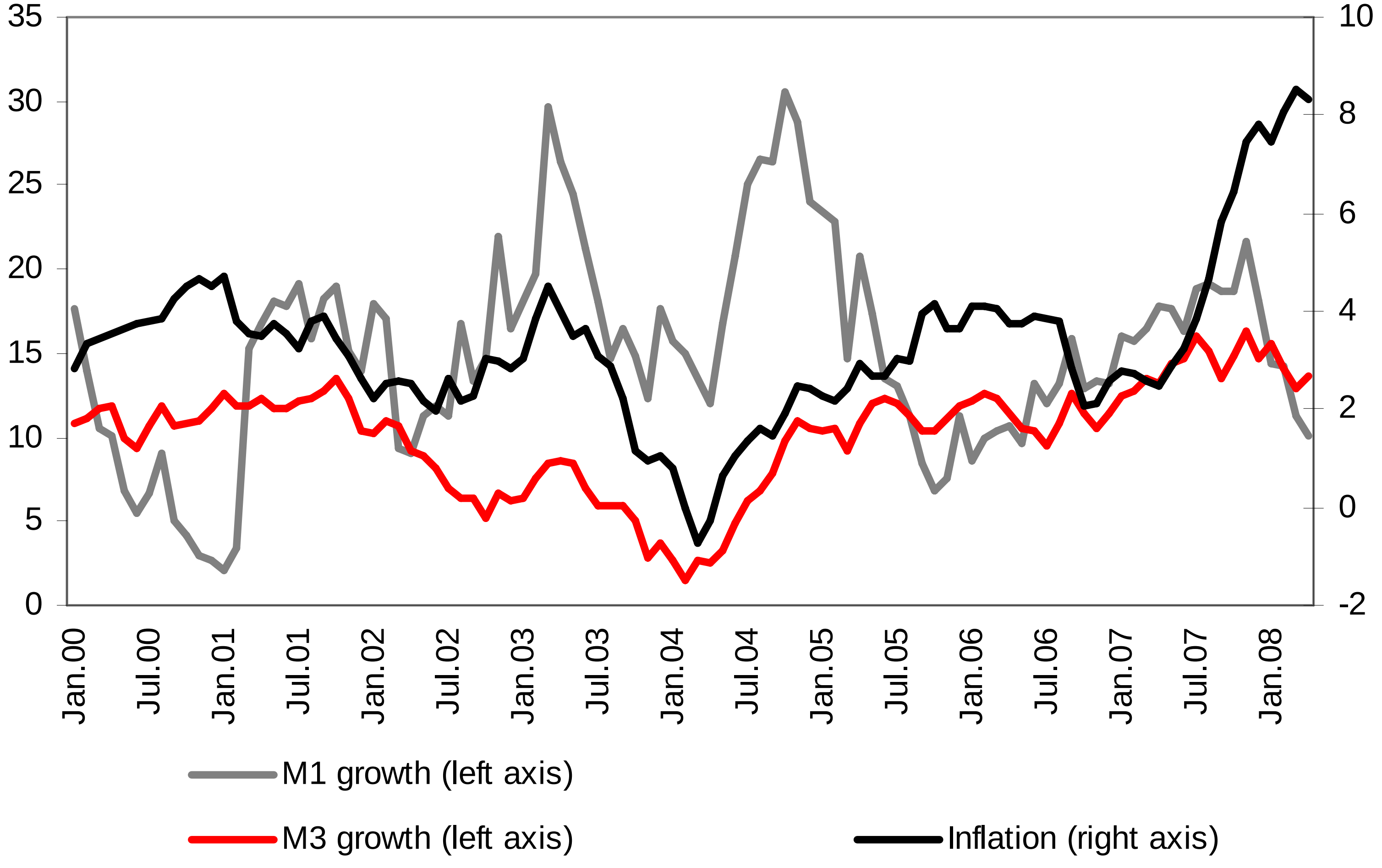
- Taylor rule vs. inflation forecast: A first approach is what to include in the Taylor rule. A more realistic, and fruitful approach is on which are the determinants of future inflation.
- Inflation forecast targeting: Models and judgment. Models are powerful tool but very limited. Judgment and auxiliary evidence are essential.
- Example: exchange rates are a common concern in developing countries. Same is true for monetary aggregates.

2. Money and Inflation Targets

- Indeed, most recent development consider monetary aggregates as indicators for inflation perspectives or stabilization goals (banking credit and money: Christiano, Motto and Rostagno, 2007; McCallum and Goodfriend, 2007)…not as the cause of inflation.
- But they could also be misleading.

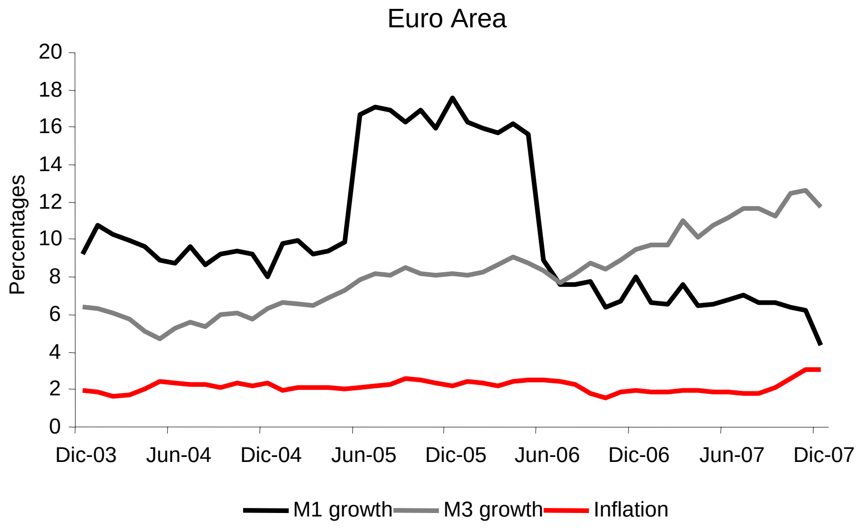
Chile: Monetary aggregates growth and inflation

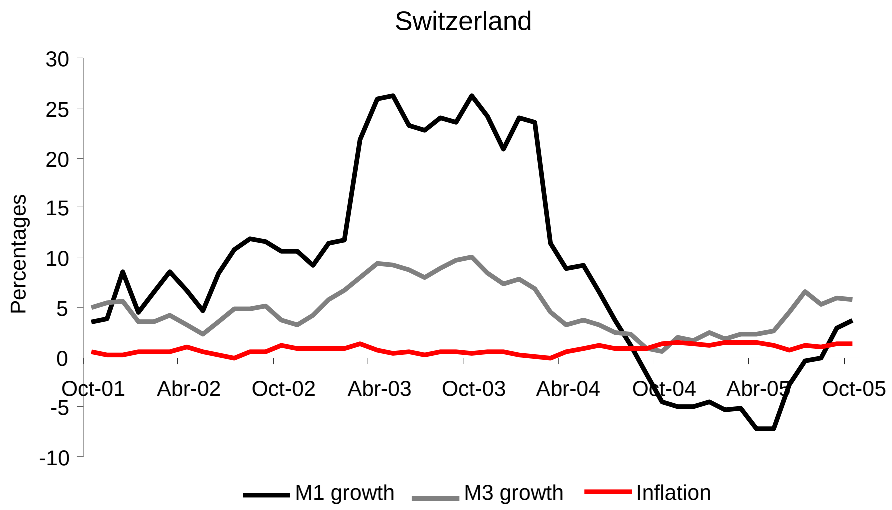
(12 month growth rates, percentage)

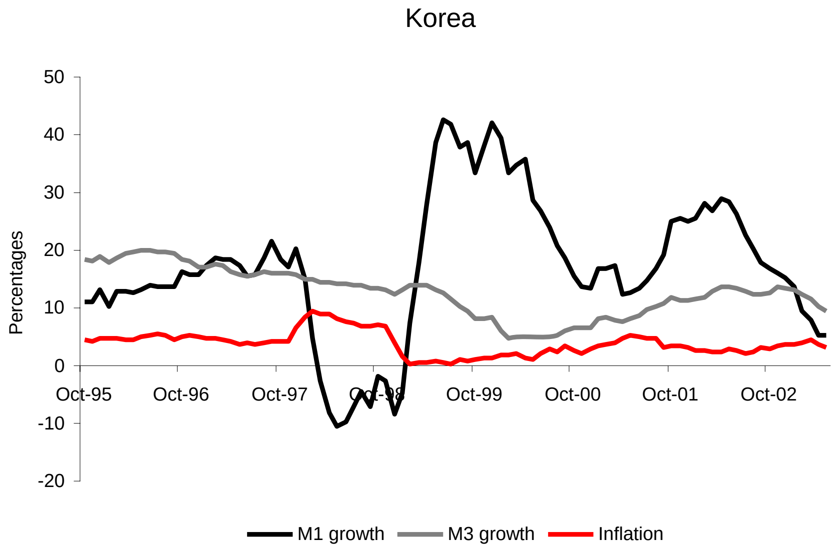


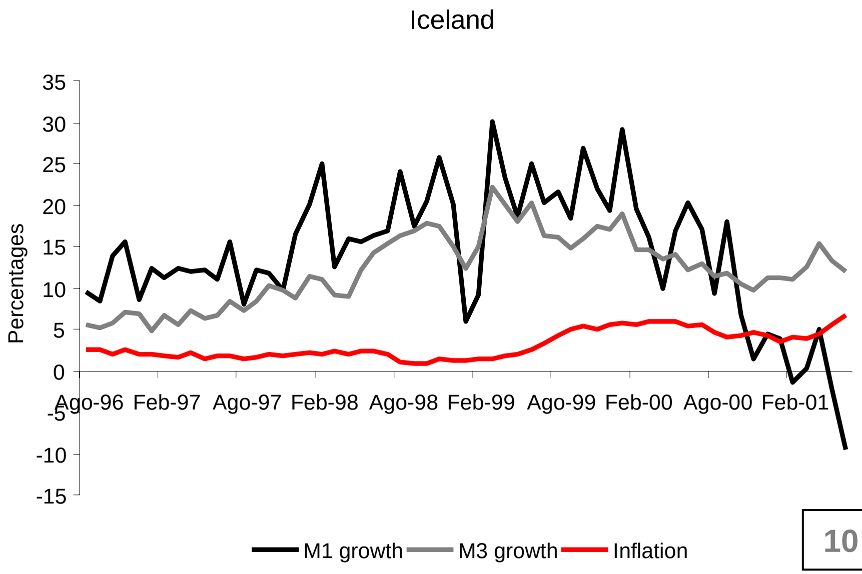
Sources: Central Bank of Chile and National Statistics Institute.

Money and inflation



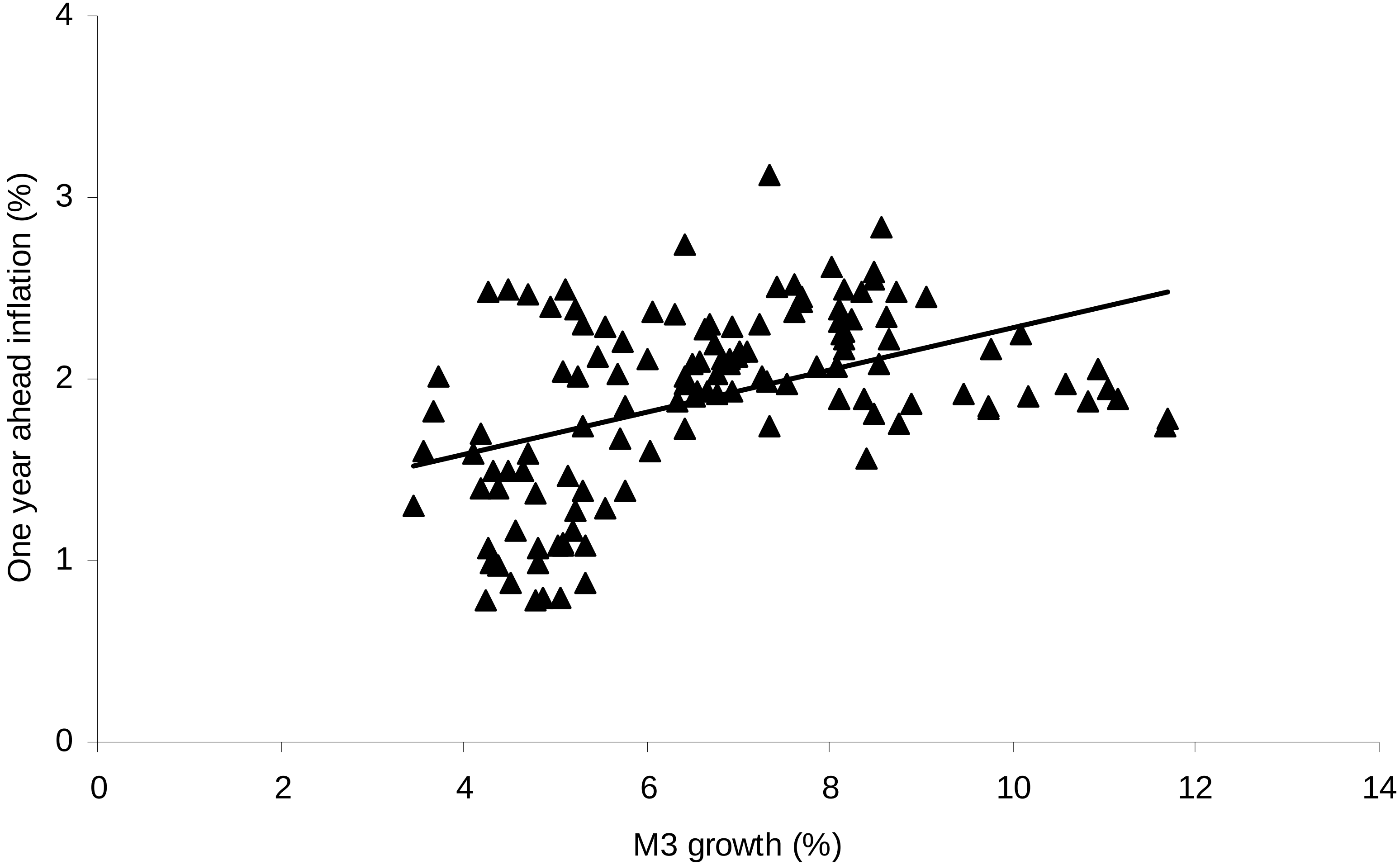






Euro Area: M3 growth and one year ahead inflation

(monthly data from January 1997 to August 2007)



Sources: IMF, Bloomberg and Central Banks.

3. Financial stability and bubbles

- Financial stability and price stability are, in general, complements.
- Sometimes they collide: USA today.
- Monetary aggregates and credit as leading indicators of financial problems. But also of inflation (Roffia and Zaghini, 2008).

3. Financial stability and bubbles

- "Wide consensus"
  1. *Central Banks should not target asset prices*
  2. *Central banks should not try to prick a bubble*
  3. *Central banks should "mop up" disasters*
- Not quite.
- Because of moral hazard 3 cannot be consistent with 1. Indeed, 3 may be the cause of bubbles and financial distress.

3. Financial stability and bubbles

- What to do about bubbles and financial distress:
  - Difficult to identify bubbles (Gurnayak, 2005).
  - Continuous financial stability assessment. Strengthen regulations, when necessary.
  - Avoid, as much as possible, bailouts because of moral hazard.
- The jury is still out.

4. Concluding remarks

- Money in modern central banking: need to clarify why and where? Money growth is not the cause of inflation. In a world of monetary neutrality and interest rate rules, money is endogenous. However, inflation is always and everywhere a monetary policy problem.
- Credit channel and banking: money could be an indicator of future inflationary pressures.
- Financial stability focus: need to look at financial aggregates and asset prices.

4. Concluding remarks

- Current very high world inflation. What went wrong? Did we miss money? Not quite, Taylor (2007).
- Need to tackle world inflation, while distortions in emerging markets are mounting.