

Christian Noyer: Does money matter? A European perspective

Speech by Mr Christian Noyer, Governor of the Bank of France, at the 4th ECB Central Banking Conference "The role of money: money and monetary policy in the twenty-first century", Frankfurt am Main, 9 November 2006.

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It is a great pleasure and honour for me to take part in this Central Banking Conference.

My communication will be organised as follows: I will first review some stylized facts about money and inflation that show that money still matters; second, I will relate these stylized facts to the two-pillar monetary policy strategy of the Eurosystem. I will conclude my presentation by addressing some interesting challenges we face in implementing our monetary analysis.

Some stylized facts about money and inflation

Let me start with a well known paradox which can be articulated in three propositions: first, price stability is the objective of all Central Banks; second, as Milton Friedman put it "inflation is always and everywhere a monetary phenomenon"; and third, nevertheless, in most countries, money has little or no part in the design or implementation of monetary policy.

There is, of course, one noticeable exception: the euro area. Before getting into more details about our approach, I would like to mention two reasons why I think money, as such, remains an essential component for the design and implementation of monetary policy.

- First, money is still of direct relevance to monetary policy in exceptional circumstances: either strong (or hyper) inflation or deflation. When Paul Volker brought down US inflation from 13 % to 3 % in three years, he did it by setting a cap on Central Bank money growth. And symmetrically, when the Japanese authorities had to fight deflation, they resorted to a "quantitative easing" policy, which basically meant they were targeting a specific amount of Central Bank money. There has been considerable debate over the theoretical underpinnings of those policies: namely whether a specific channel of transmission of monetary policy, independent of interest rates, could be identified. In any case, those experiments show, in my view, that setting a path for money growth (or its level) can prove very effective in controlling expectations - or pin down the price level - in an extreme environment.
- In more normal circumstances, however, the relationship between money and prices is more subtle and uncertain. In modern market economies, the demand for money exhibits - at least in the short and medium run - some chronic instability, if not unpredictability, a point to which I shall come back later. This has led to the demise of monetary aggregates as targets of monetary policy, and, in some countries, they have been abandoned as indicators as well.

But we still think, in the euro area, that Friedman is right in the very long run. Our research has established that low frequency movements in money growth and inflation are closely correlated, retaining fluctuations with a period of 8 to 10 years. This is because, in our view, money can directly influence output and inflation in particular due to monetary and financial frictions existing in the economy and also some stickiness in the price determination process.

Those facts underpin the two pillar approach of the Eurosystem

As you know, the Eurosystem's monetary policy strategy is grounded on two pillars: economic analysis, on the one hand, and monetary analysis, on the other. A wide set of short-term indicators (economic analysis) are complemented by the longer-term determinants of inflation (monetary analysis). This setup is based on a premise and has one important implication.

The premise is that even if money has no systematic and immediate influence on prices, it can provide valuable and specific information on future inflation, at time horizons stretching beyond those usually adopted for the construction of central bank inflation projections. Because of the long-term relation between money growth and inflation, money has leading-indicator properties on future price

developments. One could make the case that this is only an "empirical argument". But, in Central Banking, empirical realities do matter much. One could also argue that other strategies - such as targeting the price level or an average level of inflation over the long run - would have the same stabilizing properties as looking at money growth. I do not disagree in theory. But it is not clear to me that those strategies would be easier to implement or have the same anchoring effect on inflation expectations.

The implication is the need to cross-check the information on inflationary pressures and risks to price stability; this cross-checking implies that we bring together and compare different analytical strategies and that we use systematically all the information relevant to decision-making.

Of course, monetary policy does not react mechanically to monetary developments, but rather responds to the information in monetary aggregates that is relevant for maintaining price stability over the medium term. This is the rationale behind the definition of "a reference value" for monetary aggregates.

The monetary pillar supports a risk management approach to monetary policy. It allows for an early assessment and detection of potential imbalances. It sheds light on those risks at a longer time horizon than the one usually contemplated by monetary policy, but still relevant for the ultimate objective of price stability.

This is of special significance and importance when financial imbalances build up in the economy, which are fueled by excess money or liquidity growth. Unwinding of those imbalances can be brutal and discontinuous – the so called non linear reaction – and, as such, very destabilizing. Empirical evidence suggests that asset booms have typically occurred when money and credit growth were above their long-term average. Whatever the loss function and ultimate objectives of Central Bankers, all would agree that monetary policy should not willingly contribute to the formation of such credit and asset booms.

To make best use of the informational role of money, however, we have to face numerous and increasing challenges

One major difficulty is to identify in real time the nature of monetary developments and their implications for future price developments. The challenge of monetary analysis is to see through the noise in monetary data to recover those underlying trends which are relevant for monetary policy decisions. Meeting this challenge has not been straightforward in recent years as the euro area economy was hit by several shocks: financial instability in the aftermath of the stock market collapse in 2000, exceptionally high economic and geopolitical uncertainty between 2001 and 2003, just to name a few.

First of all, short-run monetary developments are often affected by transitory shocks. We need to identify and account for such temporary "special factors" or "distortions" that may affect monetary developments and blur their information content. To some extent it is the aim of the methodology developed at the ECB which allows for periodic adjustments to measured monetary aggregates in order to account for portfolio shifts which impact the demand for money without any incidence on future inflation. This approach has met with great success in the period 2000-2004.

Second, and more permanently, it is necessary to disentangle, in monetary and credit evolutions, those which reflect structural and permanent changes from those which simply result from moves in the level of interest rates and the position in the economic cycle. Here, no mechanistic or ad hoc approach would do the trick. We need to look at the fundamental determinants of money demand. Ideally, we should have a full and comprehensive model of portfolio allocation and choices which, as an aside, would produce a determination of the demand for money. We might be a long way from building such a model.

But we can have some intuitions. We could start from the fact that money is both substitutable and complementary to financial assets. Because it is substitutable, money demand depends on changes in relative returns - i.e. the actual and expected moves in interest rates. But money is also a complement to financial assets, and as such reacts to permanent changes in the supply, availability and characteristics of those assets. Our economies are becoming more and more "financial" in the sense that the ratio of financial wealth to GDP is constantly increasing. Since economic agents - especially financial intermediaries and corporates - need to keep part of their total financial assets in liquid holdings, there may be a structural increase in the demand for money (everything equal). The euro and the integration of European capital markets may have accelerated this evolution.

This could help explain the apparent break in the trend of the income velocity of money that took place in the euro area in 2000/2001. In effect, since 2001, income velocity has been declining by 3.5% a year, much faster than the rate embedded in the reference value.

According to one possible interpretation, this trend is a reflection of two consecutive shocks: from 2000 to 2004, a temporary "demand" shock, mainly reflecting portfolio shifts; and, since 2004, a "supply" shock i.e. an increase in liquid assets triggered by the fall in the opportunity cost of holding money in a context of historically low interest rates.

But the fact that this situation has now lasted since 2001 may suggest another explanation: that the apparent break in trend velocity that took place at that time is of a structural nature. On-going econometric research carried out at the Banque de France confirms this intuition. The sharp decrease in interest rates, of course has played a role. Nevertheless, econometrics seems to show that this only accounts for a very small part in the break in the trend visible since 2001. So we might be facing a permanent increase in the demand for money.

Consistent with this hypothesis is the fact that money holdings by corporates and financial institutions have grown much faster, in recent years, than those of households. Money and credit growth could then be related to a common cause: financial development and the increasing weight of financial assets in our economies.

A lot of work, however, remains to be done to fully understand the changes we are facing. This, in my view, is the beauty of our monetary analysis. It invites us - indeed it forces us – to face the complexity of our world and the ever changing nature of our environment and our behaviour. This is precisely the aim of this conference.

I thank you for your attention.