



How the Bundesbank *really* conducted monetary policy

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Received 20 July 2004; received in revised form 20 April 2005; accepted 26 May 2005

Available online 12 July 2005

Abstract

Papers estimating the reaction function of the Bundesbank generally find that its monetary policy from the 1970s to 1998 can be captured by a standard Taylor rule according to which the central bank responds to the output gap and to deviations of inflation from target, but not to monetary growth. This result is at odds with the Bundesbank's claim that it followed a strategy of monetary targeting. This paper analyzes whether this apparent contradiction is due to (a) the use of ex-post data which do not necessarily match policy makers' real-time information sets or (b) the omission of important explanatory variables. Accordingly, we compile a real-time data set for Germany including the Bundesbank's own estimates of potential output and use it to re-estimate the Bundesbank's reaction function. We find that the use of real-time data changes the results considerably. Moreover, when adding the change in the output gap as well as deviations of money growth from target to the set of explanatory variables, we find that both variables are highly significant. This suggests that the Bundesbank took its monetary targets seriously, but also responded to deviations of expected inflation and output growth from target.

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Keywords: Monetary policy; Taylor rule; Real-time data; Bundesbank

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1. Introduction

The question of how the Bundesbank conducted monetary policy is of interest not only from a historical perspective. Given that the Bundesbank is usually seen as a comparatively successful central bank, it may be helpful to better understand its monetary policy in order to draw conclusions for current monetary policy. For example, there is an ongoing discussion about the interpretation of the U.S. Fed's monetary policy in the 1970s. While some commentators argue that the Fed was responsible for the "Great Inflation" of the 1970s, because its monetary policy was too expansionary compared with a Taylor rule, others stress that such an interpretation relies on the advantage of hindsight. Today, we know that the Fed's real-time assessment of the U.S. business cycle was too pessimistic. Taking this real-time problem into account, the Fed's monetary policy could be justified even from a Taylor-rule perspective. Or, to put it differently, the Fed's policy would not have been significantly different had it in fact followed a Taylor rule.

The inflation record of the Bundesbank in the 1970s and early 1980s was better than that of the Fed and many other central banks and one could ask why this was the case. One obvious distinctive feature of the Bundesbank's monetary policy since 1975 was that it announced annual targets for monetary growth and – according to its own descriptions – based monetary policy decisions on deviations of actual money growth from these targets. However, recent empirical studies of the Bundesbank's monetary policy generally find that monetary aggregates did not play a significant role in the Bundesbank's interest rate decisions, but that its policy can well be described by a standard Taylor rule.¹

There are several ways to explain this apparent contradiction. One is that the Bundesbank did not practice the strategy of monetary targeting that it preached. Alternatively, one can question whether the econometric estimations that led to these results are correctly specified. In order to test the second hypothesis, we concentrate on two potential sources of mis-specification: (a) the above-mentioned "real-time" problem and (b) the choice of explanatory variables and the way they actually enter the Bundesbank's reaction function.

The first source of mis-specification relates to the fact that most empirical studies of the Bundesbank's monetary policy use the latest vintage of data available to the authors, i.e., they are based on ex-post revised data. This may not be adequate for the analysis of past monetary policy decisions, since some of the relevant data and estimates undergo major revisions in the course of time. By re-estimating policy reaction functions for the Fed, Orphanides has shown that the use of real-time information can considerably change the outcome of an analysis of past monetary policy decisions.² To test whether this is the case for the Bundesbank's reaction function as well, we have compiled a real-time data set which includes real and nominal output, the Bundesbank's own estimates of potential output, the rate of change in the consumer price index and the growth rate of the official monetary-target variable.

Apart from revised data, another source of mis-specification may be the choice of explanatory variables and the way they enter the reaction function. As a rule, the Bundesbank explained its monetary-policy measures with respect to its final goal, price stability,

¹ See, e.g., Clarida, Gali, and Gertler (1998), Faust, Rogers, and Wright (2001), Smant (2002).

² See, Orphanides (2001), Orphanides (2003b).

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