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Monetary analysis and monetary policy in the euro area 1999–2006

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This paper assesses the practical experience of monetary analysis at the ECB from the introduction of the euro in 1999 through 2006. The paper exploits a unique and rich real-time data set, containing both the vintages of data and the economic models that have been employed in the ECB's monetary analysis during the first eight years of Monetary Union. It embodies both a description of how monetary analysis was conducted over this period and a quantitative evaluation of the indicators of risks to price stability that derived from this analysis. A close investigation of this material is used to evaluate the role monetary analysis has played in the evolution of monetary policy in the euro area.

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1. Introduction

Since the announcement of the ECB's monetary policy strategy in October 1998, the “prominent role” assigned to money within it has been the subject of an intense debate.

To place this debate in context, it is useful to recall the broader framework for monetary policy making in the euro area. When taking interest rate decisions aimed at the maintenance of price stability, the Governing Council of the ECB draws on both economic analysis and monetary analysis (ECB, 1999b, 2003). The former attempts to identify the economic shocks driving the business cycle and thus embodies a thorough assessment of the cyclical dynamics of inflation. The latter analyzes the monetary trends associated with price developments over the medium to longer-term. While, in principle, there is no arbitrary segregation of the available data between the two forms of analysis, in

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practice the economic analysis is largely focused on developments in economic activity and price and cost indicators, whereas the monetary analysis relies on a close scrutiny of the monetary aggregates, their components and counterparts, as recorded in the consolidated balance sheet of the euro area monetary financial institutions (MFI) sector (ECB, 1999a, 2000a).¹

In contributing to this rich debate, this paper adopts a different approach from the existing literature. Rather than attempting to motivate or criticize the role played by monetary analysis in the abstract, it focuses on how monetary analysis has been conducted in practice. More specifically, the paper presents: a narrative history of the ECB's monetary analysis from the introduction of the euro in 1999 until the end of 2006; a quantitative evaluation of models used to produce money-based indicators of risks to price stability²; and an assessment of the impact of the signals drawn from the monetary analysis on monetary policy decisions in the euro area.³

From a methodological perspective, another novel and distinctive feature of the paper is the close attention it pays to maintaining a “real time” perspective when describing and evaluating the ECB's monetary analysis. In other words, the paper attempts to characterize and evaluate the monetary analysis and its impact on interest rate decisions on the basis of the information that was available at the time the analysis was conducted and the policy decisions were taken. In both the simulated out-of-sample evaluation of money-based inflation indicators and in the narrative history, the paper pays close attention to ensuring that the correct vintages of the monetary time series and analytical models are used.

The remainder of the paper is organized as follows. Section 2 provides an overview of the tools used in the ECB's monetary analysis and how they have evolved over time. Section 3 conducts a thorough evaluation of a money-based indicator of risks to price stability (which is identified in Section 2 as a “summary – but not sufficient – statistic” for the monetary analysis as a whole), addressing the real time issue carefully. On the basis of this investigation, Section 4 presents a series of event studies illustrating how the monetary analysis has influenced interest rate decisions. Section 5 presents some brief concluding remarks.

2. Conducting monetary analysis at the ECB

2.1. The structure of the briefing material

Although complemented by a large body of higher frequency material, on a quarterly basis the economic and monetary analyses take concrete form in two key exercises, the results of which are ultimately presented to the Governing Council.

The Broad Macroeconomic Projections Exercise (BMPE) is conducted by Eurosystem⁴ staff twice a year (for the June and December Governing Council meetings), with the ECB staff repeating the exercise in the intervening quarters.⁵ The exercise uses conventional macroeconomic tools

¹ The MFI sector consists mainly of credit institutions and money market funds resident in the euro area as well as National Central Banks and the ECB. Broadly speaking, one can identify it with “banks”.

² To deepen the narrative assessment, we have also constructed a number of qualitative indicators of the monetary analysis: an indicator of the input to the policy-making process made by the monetary analysis, derived from a coding of words used in briefing material provided by staff (viz., the quarterly monetary assessment discussed in Section 2); and two indicators of the impact monetary analysis had on the output of monetary policy deliberations, deriving from a coding of words used in the President's introductory statement at the press conference following the interest rate decision. (These indicators of the impact of monetary analysis on the output of monetary policy deliberations are similar to those developed by Gerlach, 2004.)

³ More information can be found in a number of appendices to the paper that are available in the version published in the proceedings of the fourth ECB central banking conference, “The role of money: Money and monetary policy in the twenty-first century” at <http://www.ecb.int/pub/pubbydate/2008/html/index.en.html>. These appendices offer more detailed descriptions of the tools and methods used to assess monetary developments from the introduction of the euro in January 1999 until the end of 2006.

⁴ The Eurosystem consists of the ECB and the (now sixteen) national central banks of the countries that have adopted the euro as their currency.

⁵ The exercises conducted by ECB staff in the intervening quarters are labeled as the Macroeconomic Projections Exercises (MPE). In the following, we will refer to BMPE to indicate both MPE and BMPE outcomes, without distinguishing between the two.

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