Money and Swedish inflation

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Received 15 August 2005; received in revised form 10 March 2006; accepted 25 April 2006

Abstract

Analysing the role of money for Swedish inflation, we apply a single equation “P-Star” model and a structural VECM for the period of the late 1980s to the beginning of 2005. Against the background of theoretical and empirical considerations, we find that money – when measured by the “price gap” or, alternatively, the “money overhang” – had a statistically significant impact on future price movements. The results suggest that money might have to play a more prominent role in monetary policy making in Sweden compared with the status quo.

\textsuperscript{1} We are grateful for valuable comments from two anonymous referees and from participants in the 2005 EEFS Conference in Coimbra.
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\textit{JEL classification:} E31; E41

\textit{Keywords:} Inflation forecast; Price gap; P-star model

1. Introduction

After being forced to withdraw from the European Exchange Rate Mechanism (ERM) in November 1992, the Riksbank’s Governing Board decided in January 1993 to adopt an explicit “inflation targeting” (IT) regime as from 1995 (Heikenstein & Vredin, 2002, p. 8).\textsuperscript{2} Since then, the Riksbank’s inflation forecasts have been playing an important role in Swedish monetary policy

\textsuperscript{2} For a detailed discussion of how IT was put into practise in Sweden, see Svensson (1999, 2001). More generally on IT, see also Baltensperger (2000), Bernanke, Laubach, Mishkin, and Posen (1999).
making. In fact, the Riksbank’s inflation forecast serves de facto as an “intermediate target” for policy making. Interestingly enough, however, economic literature on the inflation determining factors in Sweden has been relatively scarce. This article attempts to provide a contribution to filling this gap by analysing the role of “excess liquidity” for Swedish inflation.

In the last years, a great deal of monetary policy analyses has been based on New Keynesian model frameworks, in which money does not play a role in the determination of inflation and monetary policy impulses are spread solely via the real demand for goods (see, for instance Woodford, 1997). The “economy-without-money” approach is, however, neither satisfactory from a theoretical point of view, nor does it reflect the empirical evidence of the role of money as a leading indicator for inflation in a number of countries such as, for instance, the euro area. The reluctance to assign a prominent role to money when analysing monetary policy impacts on output and prices is actually quite surprising given that there is hardly any disagreement among economists as far as Milton Friedman’s famous dictum is concerned, namely that “inflation is always and everywhere a monetary phenomenon”.4

The empirical evidence for Sweden for the period Q1 87 to Q1 05 suggests that excess liquidity, as measured by the “P-star” approach, has as statistically significant impact on inflation. The results indicate that money might have to play a (more) prominent role in the Riksbank’s policy making when compared with the status quo. Especially so as measures of excess liquidity appear to contain forward looking information, supporting a monetary policy that tries to prevent rather than react to actual inflation. The rest of the paper is organised as follows. In a first step, the theoretical framework of measures of excess liquidity will be outlined (Section 2). Thereafter, an empirically estimable inflation equation will be set up and the results for the period Q1 87 to Q1 05 will be presented (Section 3). The article concludes with a summary and conclusions (Section 4).

2. Measures of “excess liquidity”

In the following, two measures of excess liquidity will be discussed briefly: (i) the P-star model and (ii) the “monetary overhang”.

2.1. The P-star model

The P-star model has become a prominent approach for calculating “excess liquidity”. It rests on the well-known “transaction equation” which can be written as follows:

\[ MV = YP, \]

where \( M \) is the stock of money, \( V \) the velocity of money, \( Y \) the real output and \( P \) is the price level. Eq. (1) simply says that the stock of money, multiplied by the number of times a money unit is used for financing nominal output, equals the real output valued with its price level. Taking

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3 For the period ranging from 1972 to 1995 Baumgartner, Ramaswamy, and Zettergren (2003) showed that narrow money M0 was a powerful leading indicator for Swedish inflation and that broadly defined money M3 as well as inflation expectations had significant predictive information for inflation: “Both monetary aggregates contain information about inflation sufficiently far into the future to allow the policymakers to respond to this information in a meaningful way” (p. 14).

4 Milton Friedman’s and his associates’ “monetarism” emphasised the importance of assigning an important role to monetary developments for prices and the economy more broadly (Brunner & Meltzer, 1972).
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