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DOES MONEY MATTER?

By

Laurence H. Meyer

In Federal Reserve Bank of St. Louis Review Sept. / Oct. 2001

A Review by Gloria A. Joseph-Raji*

I. SUMMARY OF THE PAPER

The major objective of the paper was to assess the influence of money and the role of monetarism in shaping the current thinking about macroeconomic modelling and the conduct of Monetary Policy in the United States. The author opined that the monetarist idea that Monetary Policy has primary responsibility for inflation was now conventional wisdom. However, monetary aggregates were largely absent from models used by policy analysts and from current monetary policy debates (at least in the United States). He therefore sought to explore whether current models and current practice actually undervalued the role of money.

The paper was structured along five major lines. First was an Introduction. Second, was an outline of the essential features of Monetarism. Thirdly, the author set out his interpretation of the current consensus macroeconomic model and tried to assess the role of monetarism in shaping this consensus, and next, he

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assessed the role of money in the conduct of Monetary Policy in Japan, at the European Central Bank (ECB) and at the United States Federal Reserve Bank (Fed). Lastly, he drew conclusions.

II. MAJOR HIGHLIGHTS

The author outlined the essential features of Monetarism thus:

i. Monetarism is the re-incarnation of classical macroeconomics, with its focus on the long-run properties of the economy, including the neutrality of money and the quantity theory of money. Together, these propositions identify both what Monetary Policy can and cannot achieve, and therefore delineate the responsibilities of central banks; i.e. central banks have no influence on the level or growth rate of output in the long run, but do determine the rate of growth of inflation in the long run

ii. Monetarism focuses less on the structure of the economy and short run dynamics, but more on longer-run conclusions, such as the long run relationship between money and output and money and inflation.

iii. Monetarists are sceptical of the ability to use monetary policy for short run stabilization. They favour passive rules that focus on achieving a rate of money growth consistent with price stability in the long run, with no adjustment to cushion short run fluctuations in aggregate demand.

The overriding theme across these features of Monetarism as noted by the author is that "money matters". Money matters - indeed it is just about all that matters for inflation in the long run. Monetarists believe that central banks should therefore give appropriate attention to money.

According to the author, there has been some convergence towards defining a consensus macroeconomic model in the recent years. This consensus has been typically expressed in terms of a simple three-equation dynamic model. Equation 1 is the aggregate demand equation, equation 2, the Philips Curve. Equation 3 is the monetary policy rule which relates the interest rate (viewed as the instrument of monetary policy) to the output gap and the difference between inflation and inflation targets. In other words, the conduct of Monetary Policy would entail the adjustment of the policy rate in line with ongoing economic developments.

The model, as interpreted by the author, implies that monetary policy is conducted by setting a target for a policy interest rate, without any consideration given to the prevailing rate of money growth. According to him, on one hand, the model has no apparent role for money. On the surface, the model appears to be a clear rejection of the "money matters" focus of monetarism; whereas on the other hand, the classic properties of monetarism hold in the model (at least if they are defined in terms of Monetary Policy, rather than money supply. The model seems to bypass money, but it retains the key conclusion that central banks ultimately determine the inflation rate. In order however, to determine if the model short-changes the role of money, the author focused on Monetary Policy in Japan and on the differing role of money in the conduct of Monetary Policy by the ECB and the Federal Reserve.

The author noted that in Japan, the interest rate was used as the instrument of monetary policy and was taken to almost zero, and according to the consensus model, once the policy rate is taken to zero, the Central Bank has exhausted its ability to stimulate the economy. However, the Japanese economy remained weak and

monetarists made a case for additional monetary stimulus. They argued that Japan should adopt the use of the rate of growth in the money supply as its policy instrument. It was noted that the Bank of Japan recently took a step in the direction of such a monetization strategy. While the ECB (a relatively new central bank) has as one of its two-pillar strategy, a reference value for money growth, the Fed, in sharp contrast, in year 2000, asked to be, and was relieved of the requirement of to report biannually to the Congress, on the growth ranges for M2 and other money and credit aggregates.

In concluding, the author posited that monetarism has had a profound influence on prevailing views about what Monetary Policy is capable of achieving and what it cannot do. It has also helped forge a consensus that central banks are responsible for preventing sustained inflation, and central banks have generally accepted that responsibility, but then, monetarism has not had as great an influence in terms of elevating or even maintaining the role accorded to money in either macroeconomic modelling or monetary policy. In his words, "the role of money in macro-modelling and monetary policy may have been down-played". He thus made a case for a money growth reference value in the conduct of monetary policy as an additional check on the consistency of prevailing policy with medium-term inflation objectives; and also because of the difficulty of implementing the monetary policy rule in practice. Furthermore, such a value may be particularly important at the extremes during periods of very high inflation and when the policy rate is driven to zero.

III. COMMENTS

The paper is certainly an excellent piece on money/monetarism; the current practice of monetary policy in the

United States, Japan and the European Union; and the need to accord the money growth rate more importance in formulating monetary policy strategies.

It seems ironic however, what the author brings to light in the paper that monetarism, which is all about money, has no real influence on either current macroeconomic modelling or monetary policy in the United States. After all, monetary policy refers to actions by a central bank to control the availability and cost of money and credit in order to attain macroeconomic stability.

The Central Bank of Nigeria, like the European Central Bank, adopts a monetary targeting framework in its conduct of monetary policy whereby, annually, a target money growth rate is set in line with the expected growth rate of output; and thus cannot be seen as down-playing the role of money. In other words, the Nigerian monetary authorities seem to recognise that "money matters".

A more thorough and probably empirical analysis would however be required to reach an even more definitive conclusion about the costs and benefits of a reference value for the growth of money.