For inflation fighters, money just doesn't rate
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For more than two decades, money has almost disappeared from monetary policy. Most central banks target inflation, using the short-term interest rate as their instrument.

Is there any role left for money in monetary policy?

Monetary targeting in the 1970s failed (the Canadian central bank governor complained that "we didn't abandon the monetary aggregates: they abandoned us").

The US position was explicitly put by Larry Meyer, then a governor of the Federal Reserve: "Money plays virtually no role in the conduct of monetary policy."

Only the European Central Bank still observes some commitment. The ECB's recent conference has rekindled the debate, with ECB head Jean-Claude Trichet asserting a central role for money and US Fed chairman Ben Bernanke denying it.

The sensible middle ground is held by those who argue, entirely pragmatically, that central banks should look at whatever data might help them achieve their ultimate goal, about which there is near-universal agreement. Some version of price stability is the paramount final objective.

Will analysing money (whether M1, M2 or M3) help them in understanding how the economy works, and in assessing how the economy is travelling towards the ultimate objective?

This is a purely empirical issue, where practical common sense is a better guide than theory.

Growth of credit (rather than one of the "Ms") is at least as likely to provide some extra information about the economy - maybe an early warning of an asset boom.

In this pragmatic approach, it may be sensible for central banks to follow the ECB's example and have some version of money as a "second pillar" for monetary policy (in addition to the "economic analysis" pillar), even though this has given a number of false signals in the past and statistical relationships may be ephemeral when the structure of the financial sector is changing rapidly.

Money cannot, of course, have the same status as price stability, because price stability is a desirable target in its own right, whereas money is at best an intermediate indicator which may give early insights into developments, rather than act as a final objective.

There are, however, cross-currents that confuse this debate. The first was seen recently, when one of Japan's senior economic advisers criticised the Bank of Japan for tightening liquidity too quickly.

Liquidity is a slippery concept with a range of meanings for different people, but in this context the issue is clear enough - that the BoJ was using its monetary operations to reduce the supply of base money (currency and banks' reserves) too quickly.

This idea has a long lineage, most often articulated as the Quantity Theory of Money. The Quantity Theory is an identity, so is true by definition. But to give it any operational meaning would require not only that the demand for base money is stable but that the authorities have control over it and could operate monetary policy by altering the quantity of base money. This hasn't been true for more than 20 years.

The old money multiplier beloved of introductory textbooks, with its successive rounds of credit creation, may possibly have been relevant to the regulated banking sectors of the 1970s but has no application when central banks use the short-term interest rate as their instrument - a near-universal practice for more than two decades.

When central banks set interest rates, base money is endogenous, with the public holding whatever currency it wants and the authorities mechanically adjusting liquidity to ensure the banks have enough to meet any reserve requirement and their payments system obligation.

This new world opens up the opportunity for a vigorous academic debate, especially as it requires modification of long-held economic models.

For practitioners, the important issue is to keep a clear view of what the final objective of monetary policy is (usually price stability, but never money, in any version); to keep constantly alert for any information that might help to achieve this objective (intermediate targets, including perhaps one or more of the "Ms" and credit growth); and to acknowledge explicitly that the instrument of monetary policy is a short-term interest rate, not base money.

The BoJ's Quantitative Easing policy (2001-2006) provides a case study in the impact of base money. Bank reserves were increased to 10 times their normal level, with no clearly discernible effect. The BoJ has now smoothly withdrawn this excess, again with no effect on the stance of policy or credit growth (which is determined by the interaction of the demand for credit and the BoJ's interest rate setting, not the banks' excess liquidity).

For Japan, the issue is not whether the BoJ is contracting liquidity too quickly, it is whether its interest rate setting is correct for the current and prospective economy.

Let's not accuse the BoJ of making the interest rate its target, as some critics have done. Instead, we should acknowledge that the interest rate is, indeed, the instrument, and price stability is the ultimate target. And let's go on trawling through all the data - filtered of course through the fine net of common sense - to see what clues there are on the workings of the economy so that interest rates are set to achieve price stability.

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