

## THE RENEWED IMPORTANCE OF MONITORING MONETARY AGGREGATES FOR MONETARY POLICY-MAKING

Monitoring developments in monetary aggregates has once again become a key element of monetary policy-making, according to research by **Philip Arestis**, **Georgios Chortareas** and **John Tsoukalas**, published in the February 2010 *Economic Journal*. Their analysis shows how a macroeconomic model of the economy that includes money can convey more precise information about the state of the economy, the difference between actual and potential output, and the appropriate policy responses.

The researchers note that the pre-crisis conventional wisdom had rendered money redundant in consensus models of the business cycle used for policy analysis. The New Keynesian (or New Neoclassical Synthesis) model has become the standard 'workhorse' for monetary policy analysis in the last 15 years or so.

This model has been used to address a number of questions, ranging from the interpretation of monetary business cycle stylised facts to evaluating and designing monetary policy. In this model, the policy instrument is the short-term (nominal) interest rate and money plays no role, typically resulting in a dismissal of any reference to monetary aggregates.

While the short-term interest rate has been used as an instrument of monetary policy in relative tranquil periods, it can – by reaching the lower bound of zero – quickly lose its role in times of crisis. The recent response of the Bank of England, the Federal Reserve and other central banks to the global financial crisis by directly resorting to money illustrates this issue, and highlights that it is premature to dismiss any reference to monetary aggregates.

A challenging and largely unresolved question, however, is precisely how money's role materialises. The study by Philip Arestis, Georgios Chortareas and John Tsoukalas provides evidence that money's role arises through a channel that confers important informational benefits to monitoring movements in monetary aggregates.

By monitoring developments in monetary aggregates, policy-makers can acquire useful additional information about the state of the economy and structural features that may be important for the accurate design of policy responses. The researchers develop their argument on two fronts.

First, they show that money can convey information about the state of the economy. Assessing the state of the economy accurately requires precise information about the size and the nature of unobserved shocks hitting it.

The researchers use the estimated model to quantify the nature and size of the unobserved shocks. They demonstrate that the potential output estimate improves considerably in terms of precision compared with a conventional model (which has no role for money). The increase in precision implies that policy-makers can be more confident in their assessments about the underlying potential capacity in the economy.

The importance of more accurate information about the output gap – the difference between actual and potential output – is more profound in the context of inflation targeting. This is because the size of the output gap directly affects the extent of inflationary or deflationary pressures in the economy. This improved ability of a model with money to convey more precise information becomes all the more important in the current very uncertain economic climate.

Second, the researchers examine whether adding money in such a model has implications about the way to understand the structural features of the economy. The nature of the structural features can affect monetary policy recommendations as previous research has shown.

One such feature is the fact that not all households are purely forward-looking: behavioural biases, information constraints and other reasons may lead to 'rule-of-thumb' behaviour for at least a portion of the population. In turn, rule-of-thumb behaviour determines to some extent the optimality of different policy actions for the welfare of society as a whole.

Thus, an important ingredient in this welfare calculation is the precise quantification of rule-of-thumb behaviour. Again, the model with money helps to generate more precise information on rule-of-thumb behaviour.

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**Notes for editors:** 'Money and Information in a New Neoclassical Synthesis Framework' by Philip Arestis, Georgios Chortareas and John Tsoukalas is published in the February 2010 issue of the *Economic Journal*.

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