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MONEY AND INFLATION: THE END OF MONETARISM?*

For over a decade, in a considerable number of economies the monetary policy debate has focused on defining criteria to set the interest rate, at which the Central Bank supplies short-term funds to the banking system (the so-called monetary policy rate or TPM). Thus, for the past ten years several adjustment strategies have been proposed for that interest rate as a function of the behavior of certain target variables of monetary policy, such as inflation, output, or the balance of payments of the current account. Each of these variables is included in the "interest rate rule" with a certain weight, and is measured in terms of the difference between its actual level and the target proposed by the relevant authorities.

This view of monetary policy is inspired by what has been central banking practice in industrialized economies for almost twenty years, and by the influential contribution of John B.Taylor in 1993,[1] where he proposed a conceptual framework for the assessment and administration of this policy.

Perhaps one of the most outstanding aspects covered in monetary policy discussions, and which has been set forth in several economies in the past decade, is the absence of a systematic analysis of money supply movements at the moment of defining the adjustment criteria for the TPM. Considerations about the possible instability of money demand, and monetary aggregates' endogeneity to the evolution of other macroeconomic variables, are among the explanations that have been given to justify this extensive omission of money in the discussion and analysis of monetary policy.

Some economists claim that the basic principles of monetary theory continue to be totally valid, but, in economies that have succeeded in reducing the inflation rate to very low levels, the link between inflation and money supply movements would appear to weaken substantially.[2] It is as if the very fact of attaining a considerable reduction in inflation created a scenario where belief in the authorities' commitment with price stability lead the public to disregard the capacity of short-term money supply movements to predict future inflation.

The above subjects are examined in this panel. On the one hand, the works by Herrou-Aragón and Rosende discuss, conceptually, two central issues in the

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1 John B. Taylor (1993), "Discretion Versus Policy Rules in Practice," Carnagie-Rochester Conference Series on Public Policy,Vol. 39, pp.195-214.

2 For example, see W.A. Razzak (2001), "Money in the Era of Inflation Targeting", Discussion Paper Series, Reserve Bank of New Zealand, July.

monetary theory agenda, namely: (i) the foundations –and limitations– of an approach that relies on the design and application of some kind of rule for TPM movements of the "Taylor rule" type, and (ii) the validity of the statement that contends that the monetarist approach has been displaced by other approaches that may disregard money supply movements for the purposes of explaining inflation.

The works by García and Valdés, Vergara, and De Gregorio examine the link between money and inflation from an empirical standpoint. In particular, the two first ones (i.e. García and Valdés, and Vergara's) focus their analyses on the experience of the Chilean economy in the past few years.

Possibly the most important conclusions that emerge from these works are: (i) that further empirical analysis is needed in order to establish the short-term effects of monetary policy, and that emphasis should be put on transmission channels and on the characteristics of the money demand function; and (ii) that similarly to some decades ago, when a strong debate was opened around the effects of money supply in the economy, today the design of an analytical framework to study the interaction of monetary and real variables in the short run is at the top of the list of the macroeconomic research agenda.