The Stability of Money Demand in Germany and in the EMS: Impact of German Unification

By

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1. Introduction

After the de facto break-down of the European Monetary System (EMS) in August 1993, the future of the current system is still open for debate. An increasing number of economists seem to doubt that the European Monetary Union (EMU) will come into existence at the end of this century. Nonetheless, EMU is still on the political agenda after the ratification of the Maastricht Treaty by all member countries in autumn of 1993 and the establishment of the European Monetary Institute in the beginning of 1994. Irrevocably fixed exchange rates or a common currency would necessitate a common monetary policy. Concomitantly, the European System of Central Banks (ESCB) – headed by the European Central Bank (ECB) – would have to choose an appropriate monetary strategy in order to fulfill its objectives as laid down in Article 105 of the Treaty on European Union.

Although the importance of monetary aggregates as an intermediate target for central banks has decreased in most industrial countries during the last decade, monetary targeting remains among the potential strategies for the ESCB.¹ One of the most crucial preconditions for monetary targeting would be that money demand is stable in the enlarged currency area. So far, opposing results exist in particular with respect to the stability of the aggregate demand for narrow money in the EMS.

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¹ For a theoretical analysis of alternative monetary policy strategies, including money supply targeting, nominal GNP targeting, and inflation rate targeting, see e.g. Frankel and Funke (1993).
In Section II, we briefly survey the existing results regarding the stability of the aggregate demand for money in Europe. In Section III, we expand the existing literature in several directions. On the one hand, we directly compare the stability of money demand in two selected European currency areas to the stability of money demand in Germany. This comparison is interesting because the Bundesbank has been the anchor of the EMS for a long time and has revealed a relatively close ex ante commitment to its monetary target. On the other hand, we try to assess the impact of German unification on the stability of money demand. It has been feared that the unification shock caused serious troubles that may not only be temporary but even be long-lasting. This might not be only the case for Germany but also for larger currency areas. The last section discusses policy implications.

II. The Aggregate Demand for Money in Europe: An Overview

So far, only a few analyses exist that try to assess the stability of the aggregate demand for money in Europe. The specifications of the estimated money demand functions differ in several respects: the sample period, the monetary aggregate and the currency area under consideration, the method of data aggregation, and the estimation technique (Table 1).

Most current analyses focus on the EMS period, although the observation period varies. Longer sample periods for a larger number of countries are restricted by data availability. Furthermore, harmonized definitions for broad monetary aggregates are not yet available for the EMS period. Studies focusing on broader aggregates have to rely on a number of proxies in the construction of aggregate money supply.

After the selection of the currency area and the sample period, national time series have to be aggregated by using appropriate exchange rates. Two conversion rates have mainly been used: current exchange rates or fixed base-period exchange rates (the latter measured as actual exchange rates or purchasing power parity (PPP) rates of a base year).

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2 The analysis is restricted to the consideration of narrow monetary aggregates. Until recently, broad aggregates, rather than narrow ones, have been used as indicators and/or targets in a majority of European countries. Using a narrow monetary aggregate on the European level as an indicator and intermediate target would have the advantage that the ECB could control this aggregate more easily and accurately. Furthermore, definitions for broader aggregates are not yet sufficiently harmonized.