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The Monetary Transmission Process: Concluding Remarks¹

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1 Introduction

In order to be successful in conducting monetary policy, central banks need to have a good understanding of the working of the economy, including an accurate assessment of the timing and the effects of changes in the policy instrument on inflation and economic activity – that is, the monetary transmission process (MTP). Such an assessment is necessary in order to tailor the policy response to unexpected developments in the economy and successfully maintain price stability.

The introduction of the Euro constitutes a unique experience in monetary economics and central banking. This historical regime change is likely to affect the size and the timing of the various transmission channels. Analysing the potential changes in the structure of the economy caused by the start of Stage III of EMU is therefore of great importance and will surely be an object of research for decades to come. Economists are indeed likely to regard the introduction of the Euro as a ‘laboratory experiment’ of the Lucas Critique.

However, the Eurosystem does not have the luxury of waiting for the results of this research. The Governing Council started conducting an independent monetary policy on 4 January 1999. Since then it has met twice a month to assess the outlook for inflation and decide on the appropriate policy actions. Central bankers are used to making decisions on the basis of incomplete, evolving information. As you all know, it was this lack of precise knowledge about the variable and long transmission lags of monetary policy that led Milton Friedman to warn against an activist monetary policy.

The stability-oriented strategy announced by the Council in October 1998 is designed to guide monetary policy through the uncertainties that must inevitably accompany the transition to the single currency. Of course, it is in no way a substitute for a thorough analysis of the state of the Euro Area economy, its implications for the inflation outlook and the policy actions necessary to achieve price stability. On the contrary, the implementation of the strategy presupposes a continuing investigation of the working of the Euro...
Area economy, including the transmission process. In this respect, conferences like this one are a very important source of information, particularly if they bring together such a distinguished group of outstanding researchers on monetary economics. Let me then use this opportunity to briefly give you my own reading of the key messages of the discussion.

I would like to review two key aspects. First, what do we know about the MTP in the Euro Area and, second, how it is likely to change?

2 What do we know about the MTP in the Euro Area?

There is by now quite a large literature on the MTP in the Euro Area countries. While the focus of this literature has often been on the cross-country differences and the implications for the common monetary policy, a lot can also be learned from this literature concerning Euro Area-wide transmission. Two approaches have been used which I will discuss in turn. One approach is to describe and analyse the institutional features of the economies which have a bearing on the MTP. Another is to use econometric models to estimate the effects of a change in policy-controlled interest rates on economic activity and inflation. Let me briefly review the results of both approaches.

Institutional comparison

The way in which changes in monetary policy feed through the various sectors of the economy depends to a large extent on the structural and institutional features of its financial, labour and goods markets. These institutions are rooted in the history of each country and often resulted from the interplay between particular macroeconomic shocks, the preferences and bargaining powers of various agents in the economy and more or less market-friendly regulatory and government forces.

Researchers have devoted a lot of energy to investigating whether such institutional characteristics, which from a theoretical perspective may affect the impact of monetary policy, differ across countries or regions. Often the focus on one particular aspect of the MTP leads to the conclusion that the transmission of monetary policy impulses will be very heterogeneous across Euro Area countries.

However, if one brings several of these features together (as is done in Table C1.1), then it is much less obvious that the effects of policy will be very different. Generally, countries that are particularly sensitive to policy changes because of one criterion, will be less sensitive on the basis of other characteristics. Let me briefly go through some examples.

Goods markets

One important characteristic of the goods markets which affects the transmission channels of monetary policy is the degree of openness. While the Euro Area as a whole will be a relatively closed economy – with a ratio of exports to