Divisia Money and the Monetary Transmission Mechanism

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The role of money for monetary policy analysis has changed dramatically in recent years. While the European Central Bank placed a lot of emphasis on monetary aggregates for its monetary policy analysis in the early years of the European Monetary Union, this prominent role of money has never been beyond controversy. On the one hand, the empirical literature raised doubts on the stability of euro area's money demand and, thus, on the information content of monetary aggregates for future inflation and output. On the other hand, the theoretical literature suggested that the monetary policy stance is fully reflected in the interest rate level. As a result, monetary aggregates merely disappeared from standard macro models. In the aftermath of the financial crisis, as interest rates reached the lower bound, there has been a renewed interest in the analysis of monetary aggregates for evaluating the effects of unconventional monetary policy.

It is not obvious how to measure money empirically and how to use money for identifying the impact of monetary policy on inflation, output and asset prices. Recent evidence supports a renaissance of money for monetary analysis in the U.S., particularly if money is measured by a divisia index. In contrast to traditional simple sum aggregates, a divisia index is a theory-related measure of liquidity that weights different monetary components, like currency and time-deposits, by their individual opportunity costs. So far, there is no divisia index available for the euro area that accounts for the heterogeneity of Euro area countries. This project aims to develop a divisia index for the euro area in order to investigate its information content for the monetary transmission mechanism.