Summary for non-specialists
Economic Papers No. 373 / March 2009

Money demand in the euro area: New insights from disaggregated data

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Conventional euro area money demand functions have become unstable since 2001. Two sets of arguments can be put forward to explain this instability. First, the link between the real money stock and its main explanatory variables income and interest rates could have changed because economic agents wish to hold more money for a given level of income and interest rates. Second, the strong monetary dynamics in the post-2001 period could be attributed to "special factors" such as wealth effects related to the longstanding rise in global asset prices in recent years and others factors.

In this paper, we provide evidence that rejects the first explanation. We propose an empirical approach that allows estimating the income and interest rate elasticities consistently. The approach relies on specifying a money demand equation in deviations of individual euro area Member States from the euro area average. Implicitly, this approach takes out "global factors" which have influenced the aggregate demand for money. It can therefore remain silent on empirical proxies for such factors. At the same time, the approach permits to correctly identify the income and interest rate elasticities.

Our results, supported by a number of robustness checks, show that the link between real money, income and interest rates has remained stable even in the recent period of strong money growth. Both, the income and the interest rate elasticity are in a theoretically plausible range and similar to the parameters found for euro area money demand studies prior to the recent period of instability. These findings thus provide empirical support for the judgemental procedure applied by the ECB to fix the parameters of the conventional money demand equation at the values estimated for the sample until 2001 (Fischer et al. 2006).