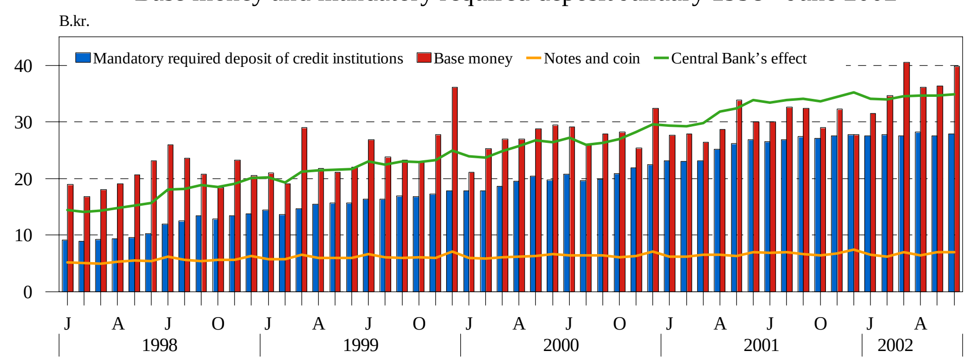
Box 1 Base money and the impact of central banks

Monetary economics posits a strong correlation between money supply and prices, i.e. increased money supply goes hand in hand with increased inflation. However, this is a long-term relationship and in spite of various attempts it has proved difficult to take advantage of it in monetary policy implementation in the real world. The impact of central banks on this correlation is mainly measured through base money, which comprises notes and coin in circulation and credit institutions' deposits with a central bank. Base money is often referred to as "high-power money" by virtue of the multiplier effect that changes in it have. The main drawback with using base money as a measurement, however, is that the measurement is generally made at a single point in time, more often than not at the end of each month. Swings in required reserves and deposits can therefore distort this measurement. Probably a more accurate criterion of a central bank's influence can be obtained by looking at the mandatory required reserves rather than the account position on any given day. The accompanying chart shows base money as measured by the Central Bank of Iceland since the beginning of 1998, compared with the mandatory required reserves for each month and notes and coin in circulation at the end of it. Base money fluctuates much more than the Central Bank's effect, making it worth considering whether to reassess base money and incorporate only notes and coin in circulation and the mandatory required reserves, as the chart does. This would make the Central Bank's involvement clearer and more logical, although the value of using this criterion might still be questionable.

Base money and mandatory required deposit January 1998 - June 2002



Source: Central Bank of Iceland.