Committee of Governors 9th July 1990

Committee of Alternates

COMMON FRAMEWORK FOR THE MONITORING OF MONETARY POLICIES

Under Article 7 of the Committee of Governors' new Rules of Procedure, the Committee of Alternates has examined the Special Report which was submitted by the group of experts chaired by Monsieur Raymond to the Committee of Governors on 27th April 1990. The results of this examination, which benefited from supplementary work undertaken by the Raymond group (see attachment), are set out hereafter.

1. General remarks

The basic approach suggested by the Raymond group in its special report has been endorsed by the Alternates with some qualifications. There has been, in particular, full agreement on the following points:

- the overwhelming priority assigned to price stability is appropriate since it clarifies the responsibility of monetary policy and reduces the risk of subsequent conflict between governments and central banks;
- even abstracting from the aspect of external publicity, the exercise is valuable *per se* because it helps the Governors to make collective and consistent assessment of the compatibility of monetary policies in individual member countries, both ex ante and ex post;
- a certain publicity is felt to be desirable in order to heighten the public's awareness that price stability is a condition for sustained economic growth, reinforce the self-discipline of policy makers and increase the Committee of Governors' profile. The Alternates consider that a judgement on the appropriate degree of publicity cannot be made until the exercise of monetary

policy co-ordination for 1991 takes shape later this year (see also Section 4);

- the exercise should be implemented in a flexible way and preserve its evolutionary character. A review of the process could be useful from time to time.

2. Analytical issues

The Alternates focused on three special analytical issues:

- the impact of financial innovation and deregulation on monetary targeting;
- consistency of monetary targets with fixed exchange rates and free capital movements;
- reliability and comparability of consumer price indices.

2.1. Impact of financial innovation and deregulation on monetary targeting

The Alternates acknowledged that rapid financial innovation and deregulation might reduce the stability of money demand and thus may affect the informative value of key monetary policy variables in individual countries. This problem has existed for some time in several countries but most central banks do not consider it serious enough to give up all forms of quantitative targeting. Most Alternates, therefore, thought that this issue should be addressed along the lines proposed by the Raymond group, i.e. that targets should be used in a flexible way in cases where signs of instability are emerging in the relationship between monetary aggregates and nominal expenditure. This would require ex post exercises taking account of changes in financial structures and the policy behaviour of a given country be judged on the basis of the whole range of indicators proposed by the Raymond group. It was also mentioned that some countries have adopted the practice of announcing ranges, rather than single numbers, for the targeted aggregates and the announcement of targets may be accompanied by a statement on the possible repercussions of a change in financial structures. Other Alternates whilst agreeing that monetary indicators should be used in a flexible way, and in conjunction with other indicators, expressed concern that the proposed approach seemed to give an unduly high profile to monetary targets, and might create a wrong impression that any departure from targets would necessarily call for a policy reaction.

2.2. Consistency of monetary targets with fixed exchange rates and free capital movements

The scheme proposed by the Raymond group provides for money supply targets in four of the bigger countries of the Community and targets formulated in terms of domestic money creation (i.e. changes in the stock of money excluding the foreign counterpart) in two other countries. If money supply targeting is applied too rigidly, there could be the risk that, given fixed exchange rates in the EMS and free capital movements, it would not satisfactorily deal with situations where capital is moving in and out of the currencies concerned. In the case of foreign exchange outflows, control of the money stock would create room for increased domestic monetary expansion with the result that outflows would continue; in the case of foreign exchange inflows, thereby boosting monetary growth, monetary policy would react by increasing interest rates which, in turn, would prompt further inflows. This would mean that tensions were perpetuated or even aggravated.

The Alternates think that, as increased freedom of capital movement is reflected in market behaviour, all, and not merely small countries, may be confronted with this problem. They support the proposal made by the Raymond group according to which the evolution of the respective domestic and external counterparts of the money stock in all countries be analysed in the ex post exercises. On an ex ante basis there should be consistency between domestic monetary policy and external monetary objectives.

2.3. Reliability and comparability of consumer price indices

Most Alternates agree that consumer price indices are a key price variable; however, given a certain lack of comparability and the fact that under certain circumstances consumer price indices do not measure correctly underlying inflation, they support the suggestion made by the Raymond group to use additional price indicators for internal purposes.

3. Policy-orientated issues

3.1. Formulation of normative price increases

The Raymond group has proposed the setting of normative price increases on an annual basis. The Alternates think that price developments certainly fall into the domain on which the Committee can express its views (see general remarks above). However, the following precautions should be taken in order to avoid the impression:

- that central banks aimed at a certain inflation rate; this would not be compatible with the objective of price stability laid down in national central banks' statutes (e.g. Germany) and the Committee of Governors' charter (see Article 3, paragraph 2 of the Decision of 12th March 1990);
- that central banks wanted to set their own targets which would possibly deviate from those of respective governments;
- that prices can solely be controlled by monetary policies.

The Alternates therefore consider that it should be made clear that normative price increases are not targets in themselves but rather a category of parameters from which money supply targets are derived. Along these lines, any communiqué should stress that the figures are working "hypotheses" or "assumptions"

3.2. Assumptions on budgetary policies

The Alternates think that, as suggested by the Raymond group, indicators of budgetary policies should be used in the proposed exercises, given the inter-relationship between monetary and budgetary policies. In special cases where the conduct of budgetary policies has a bearing on the soundness of monetary policies, the Committee might express an opinion to the governments concerned in line with Article 3, paragraph 4 of the Council Decision on co-operation between central banks.

3.3. Setting of national monetary targets in the framework of the Committee of Governors

The Raymond group proposed that targets should be set and announced in the framework of the Committee of Governors since this would, at the same time, reflect the collective character of the exercise. This suggestion raised objections, as this would conflict with statutory requirements (for instance in the United Kingdom, where the government sets and announces the monetary target, and in Germany, where the Central Bank Council is competent).

Given these difficulties, the Alternates would prefer to see the procedure concluded in two stages as proposed by one Governor at the May meeting of the Committee. First, the ex ante exercise to be held in November of each year would result in a common assessment of the desirable orientation of national monetary policies in the forthcoming target period, with special attention to the issue of compatibility. Second, the results of this ex ante exercise would then be taken into account in the national decision-making process relating to the formulation of monetary targets or projections and countries would publish these targets or projections.

The Alternates consider that such a procedure would reconcile the collective character of the exercise (as substantiated by the requirement of prior consultation laid down in Article 3 of the Council Decision of 12th March 1990) with the principle that the responsibility for formulating monetary policies remains with the individual countries.

3.4. Exchange rate targets

It was suggested that some countries would participate in a commonly agreed strategy by conducting policies conducive to exchange rate stability in the EMS. For some of these countries, however, "exchange rate stability in the EMS" may not be a sufficiently precise reflection of their exchange rate policy aims, and this formula may therefore need to be qualified further in public statements.

4. Publicity

As mentioned above, the Alternates are broadly in agreement on the usefulness of a certain amount of publicity. The legal basis is provided by Article 3 which stipulates that "the Committee may authorise the Chairman to make the outcome of the Committee's deliberations public". However, the kind of publicity and its timing should be carefully reflected upon in order to avoid the risk of impeding the frankness of discussion in the Committee, creating constitutional problems and raise undue expectations.

In the case of a two stage procedure mentioned above under 3.3, the results of the ex ante exercise itself should not be published, at least not until the method has been properly tested. However, it might be useful if the Committee issued a statement which would summarise the agreed policy orientations and might, in one version, recall the targets set and announced individually by the authorities following the ex ante exercise. The group of experts under the Chairmanship of M. Raymond has been requested to establish an example of such a summary statement. The group has undertaken this work and two alternative versions of such public statements are attached.

5. Follow-up

The Alternates recommend implementing the common framework for the monitoring of monetary policies in respect of the monetary targets to be adopted for 1991. The first ex ante exercise could be held in November 1990 on the basis of a forward-looking report from the Monetary Policy Sub-Committee.

If the Committee decided to implement the scheme by the end of the year, a decision would have to be taken on the kind of public statement, although this could perhaps wait until after the first ex ante exercise. In addition, the procedure for the preparation of ex ante and ex post exercises will have to be determined.

Furthermore, it should be recalled that the Raymond group suggested entrusting the Economic Unit with the task of studying topics relating to the elaboration of a more advanced concept of co-ordination of monetary policies (see pages 18 and 19 of the Special Report).