MONETARY POLICY AND FINANCIAL INTEGRATION: CONSEQUENCES OF 1992

1. Introduction

This note looks at the consequences for monetary policy which stem from a progressive integration of financial markets. The issue is independent from the question of a common conduct of monetary policy in a monetary union to the extent that financial markets have already become progressively integrated and the liberalization of all capital movements has been set for July 1990. The need for a closer coordination of monetary policies arises from the loss of monetary autonomy in individual countries which is the consequence of the liberalization of capital movements and a commitment towards fixed exchange rates.

2. National monetary policy: growing judgemental elements

During the last few years the judgemental element in the conduct of national monetary policy has grown. The main reason has been a lower precision in the relation between intermediate targets and final objectives. This lower precision has largely been due to two developments.

First, the significant reduction in inflation and lower interest rates have produced major movements along the money demand function. This effect is largely predictable and should be taken into consideration when monetary targets are defined. Nevertheless, it has changed the simple one-to-one relationship between money supply and nominal demand which has been the basis for monetary targets.

Second, financial innovations have led to major portfolio shifts in favour of short-term interest bearing assets. As these assets are highly liquid, substitution has probably occurred from long-term assets towards these assets but also from narrow money to short-term interest bearing assets. As these effects are hardly predictable the judgemental element in interpreting monetary aggregates has grown.

Monetary policy thus deliberately tolerated an overshooting of monetary targets when no major inflationary fears have been observed. As regards the conduct of monetary policy, the exercise of discretion has grown. In particular interest rates are moved more frequently to reconcile domestic needs and external requirements.

3. Basic principles of monetary policy coordination and present mode of proceeding

In an environment of fixed exchange rates and liberalized capital movements, monetary policy has to be geared towards a common stabilization objective. Otherwise, different stabilization standards would - at least in the long run - trigger unsustainable tensions. The common stability standard can either be derived from an ex-ante agreement among participating countries or through pegging the exchange rate to a centre currency which would then finally determine the stability standard of the system as a whole.

Exchange rate stability and liberalized capital movements require also agreement on the role to be played by monetary policy. Should monetary policy, as in the UK, play an active role in stabilizing the economy in the short run or should it, as in the FRG, provide the medium term frame for private economic decisions? Obviously very different models exist in Community countries, impeding common monetary decision making. Moreover, a change in the role of monetary policy would have implications for the conduct of other policies, in particular for fiscal policy, which would have to play a more discretionary role in case monetary policy follows a medium-term-oriented strategy.

Fixed exchange rates and liberalized capital movements would require a common view as to the effects of monetary policies. This is crucial in deciding upon the optimal response to internal or external shocks. If, for example, one country underestimates the inflationary effects of a depreciation of its currency while it is particularly concerned about the effects on domestic activity and/or the external balance, the response would be different compared to a situation in which greater weight is put on the implications for domestic inflation. Therefore an ex ante agreement upon a common dollar policy seems to be particularly necessary.

Finally, to the extent that other policies trigger expectations of exchange rate movements, a high degree of compatibility of these policies with the nominal exchange rate commitment is required. Thus budget deficits should not be permitted to become unsustainable and wage developments should not be permitted to worsen the competitive position in the medium term.

At present monetary policy coordination follows a discretionary and judgemental approach. Dollar interventions, which are mainly sterilized, take place after bilateral ad hoc coordination among central banks. Within the EMS, stabilizing asymmetric interest rate measures were frequently taken in order to stabilize the

system. However, differences in judgements continue to persist as to the optimal level of the dollar and the required overall stance of monetary policy in the EMS.

4. **Monetary policy coordination through rules**

The main advantage of a monetary policy coordination relying on rules would consist in reducing the judgmental element in the conduct of policy. Two propositions are frequently put forward: a common monetary target for the area in which exchange rates are fixed; individual credit targets and unsterilized interventions in the system.

(a) **Common monetary target**

The concept of a common monetary target suffers from the fact that the substitutability of currencies is limited as long as the exchange rate is not unequivocally fixed. Therefore, although the substitutability of currencies will increase in the process of monetary integration and increasing exchange rate stability, interpretation of the overall money supply would remain difficult. And while a process of gradually increasing substitutability would tend to reduce this problem over time, it would tend to create another: national monetary aggregates would become less good indicators of domestic activity.

From an operational point of view, the common monetary target would have to be derived from national monetary aggregates. These would have to be based upon a common inflation objective and, given the inflation objective, the prospects for real growth. To the extent that the growth of productive potential in the Community countries differed, national monetary aggregates should increase at different rates.

The definition and interpretation of aggregate monetary variables as well as the response to potential deviations from a target raise specific problems. In addition to the theoretical preoccupations, definitions of national monetary aggregates deviate with respect to the inclusion of foreign (domestic) currency holdings of residents (non-residents) with domestic or foreign banks. This involves the risk of double or non counting of such deposits in the overall aggregate. A greater substitutability of currencies could render this problem more relevant than in the past.

An overshooting of the aggregate monetary target will have to lead to coordinated, but asymmetrical national policy measures. Deciding these measures would largely have to be based upon judgemental elements.

(b) **Individual credit targets**

The suggestion of domestic credit expansion targets is founded on two elements: ex ante and mutually agreed targets for domestic credit expansion in each country, consistent with monetary stability and a rule whereby the effects on money creation of intra-EMS interventions are not compensated by changes in credit to the domestic sector.

Domestic credit targets can be defined independently thereby preserving some kind of national influence on the common monetary policy in a fixed exchange rate system with full capital mobility, but if they were not consistent with the same stabilization objective for all countries, the system would run the risk of becoming an average inflation system.

The approach requires a strongly symmetrical management of foreign exchange interventions in the system. Then, unsterilized interventions produce a symmetrical change in the monetary bases in the intervening countries. However a given increase in the monetary base will have different impacts on the money supplies of two countries as money multipliers are different.

Another problem of a monetary policy relying on rules relates to the policy response movements of third currencies. Perfectly flexible exchange rates can, in certain circumstances, contradict with optimal monetary policy behaviour of the areas. Therefore each approach has to be complemented by an agreement on a common policy, in particular against movements of the dollar.

5. Competition of financial systems and consequences for monetary policy instruments

The greater integration of financial markets will increase the competition between financial systems. This will result in the creation of short term interest rate bearing assets, which will furthermore blur the borderline between monetary and non-monetary assets. In any case, the higher degree of substitutability between monetary and non-monetary financial assets could have a destabilizing effect on the velocity of, in particular, broad monetary aggregates, which could be particularly important in the transition phase towards further integration. If one takes into consideration the possibility that monetary deposits in foreign currency might become close substitutes for domestic short-term financial assets, the definition of an appropriate monetary target is becoming more important.

Because of growing competition among financial systems, the banks in several member countries will have to operate under similar operating conditions. This raises the question of minimum reserve regulations: to the extent that they are detrimental to the domestic banking sector and not compensated for by privileged access to central bank money, integration will lead to further credit substitution and bank disintermediation, i.e. transactions will take place with foreign banks or outside the banking sector.

While such effects are unlikely to occur suddenly, two other factors might lead to a significant shift towards currency holdings with foreign banks. First, it might be advantageous to hold monetary assets with foreign banks if this enables the evasion of tax payments. Second, domestic financial placements might be considered unattractive if the possibility of a reintroduction of capital controls is credible.

6. Tentative conclusions

It appears that by 1992 the judgemental element in the conduct of monetary policy in the Community will increase with financial integration as the relevance of national monetary targets will be blurred. Too simple rules are not recommendable from a theoretical point of view and in any event hardly operational. Coordination between monetary authorities should be enhanced and this would necessitate a fuller agreement on the objectives and the role of monetary policy in the overall macroeconomic policy approach. Some harmonization of institutional regulations as regards taxes on interest revenues and monetary instruments (minimum reserve requirements) is important when competition among financial systems is growing.

*

* *