
Economic Unit

**FURTHER ISSUES FOR DISCUSSION
FOR THE AUTUMN 1994 EX-ANTE CO-ORDINATION EXERCISE**

Previous discussions have indicated that the issue of the compatibility of monetary policies is intertwined with the quest for an acceptable degree of exchange rate stability and with the issue of the appropriate degree of monetary policy differentiation across Community countries. This note puts forward some questions which may help the assessment of monetary policy compatibility.

1. Monetary strategies and intentions for 1994

The draft Report has implicitly assumed that, for most countries, national monetary policy strategies continue along the lines followed since the widening of the ERM bands. However, the new environment might induce authorities to take new directions. More information on this issue, as well as on the specific monetary policy intentions for 1994, would render more effective the assessment of national monetary policies and of the overall stance.

- *Could delegates specify somewhat more precisely their current thinking on their country's overall monetary strategies in the new context, as well as details of monetary policy intentions for 1994, based on best guesses if necessary?*

2. Differentiation of national monetary policies and the single stance

At the last meeting of the Sub-Committee, quite different opinions were expressed regarding the need for monetary policy differentiation within the Community in the current conjuncture. Some members expressed the view that unless German interest rates are quickly and substantially lowered, domestic conditions elsewhere would require significantly differentiated national monetary policy stances. By contrast, others argued that - as a result of the synchronised cyclical position and the relatively more similar inflation patterns which at present characterise the Community - the monetary policy stance appropriate to current economic conditions is basically the same for all countries.

- *What is the assessment of the Sub-Committee regarding the need for a substantial degree of differentiation in national monetary policy stances? Is this assessment contingent on the path envisaged for monetary policy in Germany?*

- *If the Sub-Committee were to conclude that current economic conditions do not warrant a high degree of monetary policy differentiation, would this imply that the concept of common monetary stance can continue to be straightforwardly employed, in spite of the wider fluctuation bands in the ERM?*

3. Interest rate policies, exchange rate movements and compatibility of policies

The assessment of national monetary policies based on domestic economic conditions naturally has to be complemented by an evaluation of the implications of national interest rate policies for exchange rates. At the last meeting in fact, the Sub-Committee expressed a marked aversion for sharp movements in exchange rates, even if they were to take place without the risk of reaching the limits of the fluctuation bands. At the same time, it was recognised that the uncertainty still prevailing in foreign exchange markets makes it more difficult to assess the possible effects on exchange rates of national interest rate policies. Furthermore, as noted above, most countries have not yet precisely defined and made public either the implications of the widening of the ERM fluctuation bands on their monetary policy strategy, or the specific monetary policy intentions for 1994.

- *How relevant are these considerations for the assessment of the compatibility of national monetary policy?*

- *If the Sub-Committee were to conclude that a marked differentiation in national monetary policies is required on the basis of the domestic economic outlook, under which conditions would the implied differentiated pattern of national interest rates be considered compatible with the broad maintenance of current exchange rates? If such a high degree of monetary policy differentiation were instead to be seen as implying undesirable movements in exchange rates, which considerations would guide central banks in solving such a dilemma, in many respects analogous to the one which used on occasion to arise in the ERM with narrow bands?*

- *Conversely, if the Sub-Committee were to consider that current economic conditions do not require a high degree of differentiation in monetary policies, would the implied national interest rates be expected to be conducive to exchange rate stability, interpreted as the absence of sharp movements within the 15% band? Or, is there the possibility that even a low degree of monetary policy differentiation within the Community might be associated with further movements in exchange rates?*

- *Would the definition for internal purposes of threshold values for the exchange rates ("target zones" to be monitored in the confidential discussions between central banks) be helpful in the evaluation of policy compatibility? Are there any concrete steps which could be undertaken to facilitate the assessment of the compatibility of national monetary policies stance? Or is the present level of uncertainty so intense, especially as regards the effects of interest rate movements on exchange rates, as to make any sound evaluation on the ex-ante compatibility of policies virtually impossible?*

[4. Risks

In the previous Issues for Discussion note, the Economic Unit put forward a number of risks which could impinge on the conduct of monetary policy in the period ahead.

Which, if any, among these risks is the most serious threat to the mutual compatibility of national monetary stances?]