6 October 2000

LAUNCH OF NEW BOOK ON MONETARY POLICY FRAMEWORKS

At a function today at the Bank of England's Centre for Central Banking Studies the Governor of the Bank, Sir Edward George, launched the book "Monetary Policy Frameworks in a Global Context", edited by Lavan Mahadeva and Gabriel Sterne.

He said, "The analysis of this book should be of enormous value to professional economists and students alike, and the data that have been gathered are an excellent information source."

The publication includes general lessons drawn in a report prepared for the 1999 Central Bank Governors' Symposium held at the Bank of England. This includes one of the broadest-ever surveys of monetary policy framework characteristics, covering 94 monetary policy frameworks. Within this large sample, there are frameworks with many different forms and combinations of policy targets as well as institutional arrangements that incorporate varying degrees of accountability, independence and transparency, along with a variety of analytical methods that inform key decisions.

The Report also seeks to identify where the search for best monetary policy practice has found common ground and also distinguishes the circumstances under which countries might choose frameworks which depart from the norm.

The second part of the book contains specific lessons drawn from renowned monetary policy researchers and practitioners, and the wide range of experiences assessed provide a perspective on the how the evolution of monetary policy frameworks over the past 30 years has depended on structural differences, factors affecting the speed of the transmission mechanism, and institutional arrangements and analytical constraints that influence the way in which monetary policy can respond.

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Notes for Editors

A summary of the Report referred to above, follows.

“Key Issues in the Choice of Monetary Policy Framework”
a Report prepared for the 1999 Central Bank Governors’ Symposium by
Maxwell Fry, DeAnne Julius, Sandra Roger, Lavan Mahadeva and Gabriel Sterne

Published by Routledge, October 2000 in the book: **Monetary Frameworks in a Global Context**
edited by Lavan Mahadeva and Gabriel Sterne

Monetary policy framework designers were particularly busy during the last decade. Some countries made historic shifts toward currency union. Others moved towards greater exchange-rate flexibility, developing their domestic nominal anchors to guide expectations more effectively and develop credibility. The spur for this book was the sixth annual Central Bank Governors’ Symposium held at the Bank of England in June 1999, where over 50 central bank governors met to share views on the important global developments of monetary policy frameworks.

The authors’ objectives were to identify areas where the search for best monetary policy practice has found common ground, for industrialised, transitional, and developing economies alike. They also sought to distinguish circumstances that might lead countries to choose frameworks that depart from the norm. When is it best to target inflation, or money, or exchange rates? What consensus exists on the ideal degrees of independence, accountability, and transparency for the central bank? When might the use of certain types of macroeconomic models and other forms of analysis be most appropriate? *Key Issues in the Choice of Monetary Frameworks* maps each of these, using one of the largest and most comprehensive ever surveys of central bank policies, practices, and preferences covering 94 central banks in economies that together account for over 95% of global GDP.

Chapter 1: Introduction

By comparing experiences in a broad range of economies, the survey shows how the detailed characteristics of a monetary policy framework depend upon:

1. Structural differences, e.g., the structure of the financial sector, types and amounts of debt, openness to trade, commodity dependence, fiscal discipline, etc.
2. Varying degrees of indexation and other nominal rigidities that affect the speed of transmission from monetary policy instruments to inflation.
3. Institutional arrangements and analytical constraints (such as data availability) that influence the way in which monetary policy can respond.

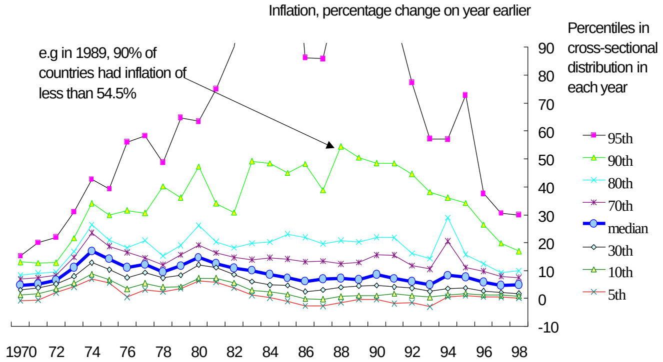
To devise a framework for the conduct of monetary policy in a particular country, it is first necessary to know what monetary policy can and cannot do. It could be argued that a debate remains about the appropriate objectives of monetary policy. On the one hand, a few central banks advocate that monetary policy can and should be targeted at employment and economic growth in addition to price stability. The alternative, more commonly held view is that monetary policy should be directed solely at price stability.

The apparent conflict between these two views is resolved if it can be established that monetary policy is conducive to high employment and growth only if it maintains stable prices. In such a case, price stability is a necessary condition for sustained economic growth and there is no conflict between the two objectives: they always imply the same policy in the long run. This could be one reason why the survey revealed that price and currency stability (monetary stability) is primary among the statutory objectives of most central banks.

(a) Chapter 2: An historical examination of inflation stability

By the end of the 1990s, global inflation was lower than at any time since the breakdown of Bretton Woods in the early 1970s. No matter what route was taken, the 1990s saw steadier prices almost everywhere. Chart 2.1 (page 19 of the book) illustrates that annual inflation stood at 25-year lows in many countries by the end of the 1990s, and that such reductions mirror the rapid increases in inflation following the oil price shocks of the 1970s

Chart 2.1.
Cross Sectional distribution of inflation rates in 91 economies, 1970 to 1998



Note: Data taken from 91 developing and industrialised economies for which data are available in each year 1970 to 1998. Data for 1997 and 1998 includes estimates
Source: World Development Indicators (World Bank) and International Financial Statistics (IMF).

Explanation of chart: Chart 2.1 illustrates the cross-sectional distribution of inflation rates across 91 economies for which continuous inflation data exist between 1970 and 1998. For example, the lowest line on the chart is the 5th percentile of the global inflation distribution, and the lowest point on this 5th percentile line shows that in 1993, 5% of countries in the sample had inflation below -3% (i.e. deflation of over 3%).

The Circumstances of Inflation Stability

Nowadays, most policy-makers need little convincing that stable inflation is a good thing. But is low inflation necessary to secure stable inflation? The historical context suggests the answer is usually yes. The authors establish the result that very low rates of inflation (below 3.8%) appear to provide inflation with its most natural home insofar as once inflation is low, it has been more likely to stick.

Which countries and using which framework have achieved low stable periods of inflation? Here there exists a contrast between industrialised and developing economies. Industrialised economies have achieved low, stable inflation using each of money, exchange rate and inflation targeting. In stark contrast, there are no examples of a developing economy achieving a five-year period of very low (under 3.8%)or low inflation (3.8% to 7.4%) other than through fixing the exchange rate. In other words, there are no precedents in these data for developing and transitional economies successfully using a domestic nominal anchor to achieve price stability.

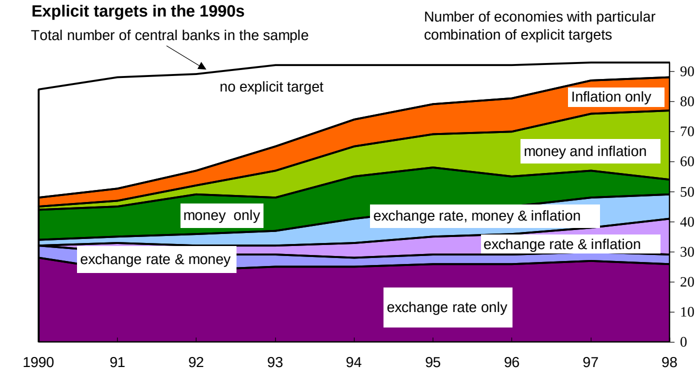
The authors point out, however, that this does not necessarily imply that such economies will be unable to achieve stable inflation in the future by means of domestically oriented monetary policies, particularly given the developments in policy frameworks that are detailed in the book.

(b) Chapter 3: The use of explicit targets for monetary policy

The rapid increase in the use of explicit targets in the 1990s (shown in Chart 3.2 on page 34) is one of the most striking trends outlined in the Report. The number of countries with inflation targets, for example, increased over tenfold, from 5% to 58% of the sample. There were no cases of a country dropping its explicit inflation target in the 1990s, with the exception of those joining the European single currency.

Many countries by the end of the sample used more than one explicit target. There has been a long-standing economic literature which treats targets as alternatives, yet central bank practices in the 1990s confound such a treatment. In 1998, nearly half the economies in the sample announced an explicit target (or monitoring range) for more than one of the exchange rate, growth in money or credit, and inflation, compared with only 8% in 1980. In 1998, there was an average of 1.5 announced targets for each country.

Chart 3.2:
Explicit targets in the 1990s



Note: Money targets include all targets for different definitions of money and credit period
Source: Bank of England survey of monetary frameworks, Cottarelli and Giannini (1997) and IFS (various issues)

Rules versus Discretion Revisited

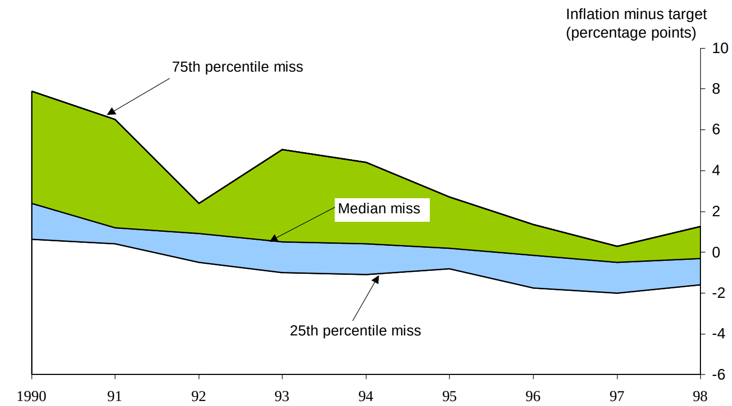
The choice of policy target for monetary policy has usually been framed in terms of the controllability of a particular variable and the stability of the relationship between that variable and the final objective. Yet it is hard to explain some countries' choice of targets using such a framework. Why do so many liberalising countries with poor data and unstable velocity use money targets? Why do other countries that have poor data and are vulnerable to supply shocks use explicit inflation targets? Are 'explicit targets' in some cases better described as benchmarks for variables, against which outcomes can be usefully measured and deviations analysed?

Such a view is one to which the authors adhere. They use a unique data set of target "misses" for all the countries in the sample that announced inflation and money targets during the 1990s. The authors use the data to answer particular questions:

- *To what extent does the increased use of explicit targets indicate a more rigid approach to monetary policy?* The median absolute inflation target miss in the sample was 1.5%, a figure that is supportive of the use of such targets as part of a strategy of "constrained discretion" (see chart 3.3 on page39)

- *Are the results for inflation target misses suggestive of bias—i.e. do outcomes tend to overshoot or undershoot the target on average?* To the extent that unexpected shocks even out over the sample period, the results suggest that central banks have, on average, been realistic in setting inflation targets.
- *Are money targets implemented with differing degrees of flexibility from inflation targets?* The median inflation target miss (in absolute terms) for countries that announce both inflation and money targets is 1.5 percentage points, compared with 3.2 percentage points for broad money growth. The results are consistent with the view that over a broad range of countries, the mix of shocks leads to greater deviations from money targets than inflation targets.

Chart 3.3
The distribution of inflation Target "misses" in the 1990s



Explanation of Chart. Chart 3.3 (page 39) shows the average performance relative to inflation targets and the distribution of misses for broad money growth and inflation targets. In each year of the 1990s the charts show the median miss, plus the value of the miss for the country at the 25th and 75th percentile of the distribution. Thus the shaded area encloses the outcomes for the half of the sample with the smallest misses above and below the target

The role of the target in defining a relationship between the central bank, the government, and the private sector

Both money and inflation targets have been used flexibly in many countries, yet a marked difference in the means by which they are used to define a role in the monetary strategy for each of the central bank and government.

Chart 3.1 (on page 31 of the book) represents the responses of 93 central banks when asked whether they or the government set the explicit target, or whether the target was set jointly.

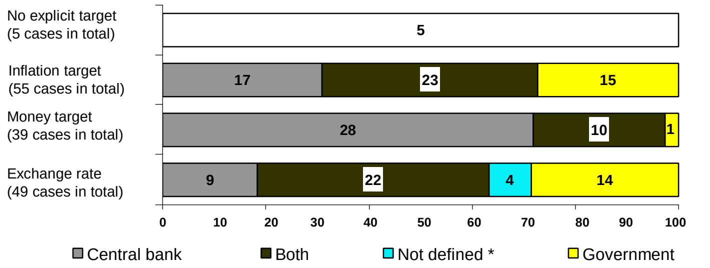
Central banks usually have responsibility for setting the money target. In contrast, an important function of explicit inflation targets has been to define the roles of the government and the central bank in the monetary policy strategy

The global experience offers a variety of approaches that may contribute to improved coordination. In a contractual approach (as used in the UK (see pages 226-242) and Israel (see pages 484-524), the government sets a target and provides the central bank with operational independence to pursue the target.

Sometimes, however, it is difficult to specify objectives on which a contract can be clearly defined. For countries that are undertaking disinflation, for example, there are often at least two inflation targets: one for the current period and one for the long run. Where contracts become complicated, an alternative approach may be for the government and the central bank to agree on an explicit target, in order to emphasise joint ownership of the monetary strategy. Finally, where the institutional arrangements have been designed to afford a high degree of central bank autonomy, progress towards price stability may have been achieved through 'target independence' (see the case of Chile, pages 455-483).

Chart 3.1

Who sets explicit targets and monitoring ranges for the exchange rate, money, and inflation?



Note: From a sample of 93 central banks describing their practices in late 1998 (with some revisions for changes made in 1999, but not including changes in EMU countries): The figures in the bars indicate the number of economies with this arrangement. The length of the bars indicate the percentage set under different arrangements.
* These mainly include countries that are defined by the IMF as having a fixed exchange rate, but do not announce an explicit target.
Source: Bank of England survey of monetary frameworks

The comments of successive Governors at the central bank symposium (pages 182-205 of the book) forcefully reiterate the point that a major contribution of inflation targets has been in improving monetary and fiscal coordination in these economies.

d) Chapters 4-6 Transparency, accountability, independence and other framework characteristics

Any monetary policy aspires both to anchor long-term inflation expectations and to react efficiently and effectively to economic shocks. The report suggests that policy-makers across a very broad range of countries have striven to achieve these goals by affording central banks greater instrument independence, while central banks themselves have sought to widen support for low inflation through greater openness and accountability.

The diversity in frameworks reflects the desire among policy-makers to react flexibly to a wide variety of shocks, while not undermining the anchor for long-term inflation expectations. The rich diversity of experiences assessed in this book provides a wide perspective on the evolution of monetary frameworks over the past 30 years. During that time there has emerged an increasingly strong public constituency for low inflation. The legal objectives of central banks have become increasingly focused on price stability, backed up by an ever-widening use of numerically specified inflation objectives. And policy-makers have sought to anchor long-term inflation expectations by granting many central banks a greater degree of independence.

According to central banks, the most important features of their monetary frameworks are central bank independence and the maintenance of low inflation expectations (page 133).

There exist many forms of central bank independence, some of which are measured in the Report. Chapter 6 of the report seeks to establish which of these are most important to central banks by supplementing these with two questions requiring subjective answers from central banks, namely:

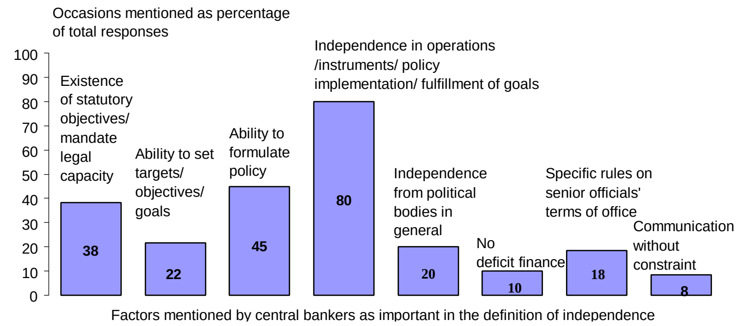
- How would you define central bank independence? and
- To what extent can your central bank formulate and implement policy without the constraint of government

This analysis of the results leads to two main conclusions:

(i) Central banks define independence as an absence of factors that constrain their ability to set instruments in pursuit of objectives (see Chart 6.1 on page 111). The discussion of Governors from developing countries (e.g. page 199) vividly illustrates that fiscal policy remains very important in that regard.

(ii) The ability to set targets independently of the government was not generally considered to be important in countries targeting inflation in low-inflation economies. For disinflating countries, however, it has proved harder to devise clear 'instrument-independent' relationships between central bank and government based on inflation targets, in which government sets a clear target and the central bank sets instruments to meet the target.

Chart 6.1.
How central bankers define independence [1]



[1] The responses are the authors' categorisation of answers to the question "How would you define central bank independence?" There were 60 usable responses (23 from industrialised economies and 37 from developing and transitional economies). Respondent cited an average of 2.9 categories in industrialised economies and 2.2 in developing and transitional economies.

Remarkably, central banks rank transparency as the third most important aspect of the monetary framework, a reflection of the very considerable changes in the role and outlook of central banks in recent decades.

The authors argue that ‘it is better to have narrow objectives and be obliged to explain misses rather than having imprecise objectives that make success or failure difficult to measure’. Whichever target is adopted, it is highly unlikely that the optimal strategy will always be to maintain policy exactly on target. And a target miss coupled with a convincing explanation for the miss is unlikely to significantly undermine credibility.

Adoption of explicit domestic targets, then, provides momentum for a heightened role for explanation in monetary strategy, a trend which is clearly evident in all types of economies from the detailed responses in the report, and an important role for the now-thriving cottage industry of research that assesses optimal target specification, policy rules, and monetary conditions, examples of which are contained in this book.

Where the momentum for transparency began is disputed. Certainly the inflation-targeting countries, starting with New Zealand, provided impetus with numerous framework innovations in transparency and accountability that have now been adapted in many other countries around the world. Yet, as Adam Posen (pages 393-42) points out, there are strong arguments for citing the Bundesbank as an earlier pioneer of central bank transparency. He attributes one of the most enduring stories of successful macroeconomic management- the Bundesbank's performance in the 41 years between its founding and European monetary unification- partly to the transparency and flexibility of the German monetary framework, and not just to the more commonly cited factors of formal independence from political control, a legal mandate committing it to price stability as the ultimate policy goal, and monetary targets. Independence, after all, cannot be sustained in the long run without political support.

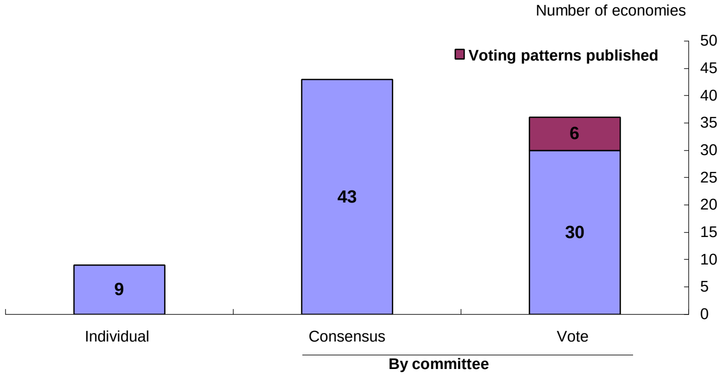
e) Chapter 7: Redesigning the monetary policy framework

The choice of monetary policy framework is no longer a technical, academic topic to be debated behind closed doors leading off the corridors of power. There is an active public interest in the subject, which is only fitting in view of the widespread costs that result when the framework for delivering price stability fails. In today's world, public accountability and political sovereignty are central elements in the design of a country's monetary policy framework.

Whenever a framework is chosen, many design details will have to be determined. These mundane considerations can make or break the new system. Yet the economic literature provides little guidance on questions such as the relative merits of committee versus individual decisions, or how committee decisions should be taken.

For example our survey shows that a policy-making committee is more common than an individual decision-maker. Chart 7.3 shows the distribution of responses to the survey question, 'Who takes the decision to change the main monetary policy instrument?' In only nine countries is the decision taken by an individual, while 79 countries use a committee structure. Slightly less than half of the committees have a procedure for voting, while the other half take a decision by consensus. Six of the 36 voting committees publish the votes of individuals.

Chart 7.3
Monetary policy decision procedure



Note: the countries publishing individual votes are Japan, Korea, Poland, Sweden, The United Kingdom and the United States.
Source: Bank of England Survey of monetary frameworks.

Other points

This year's symposium report and proceedings are accompanied by a group of papers that were first presented at a workshop on policy targets run by the Centre for Central Banking Studies.

At the workshop, twenty-eight central banks sent experts to exchange views with each other as well as with leading experts from academia and international institutions.

And the workshop was followed by a three-month research project involving representatives of the central banks of Chile, the Czech Republic, Hungary, Peru, and Uganda as well as the Bank of England.

The fruits of all these events are contained in the book. So following the global picture painted by the Symposium Report, the book provides a wealth of detailed experience from particular countries and relating to particular to issues. The authors in the book come from countries with very different economic histories and experiences. And the contributions are made not only by distinguished experts with vast experience in formulating monetary policy, but also by researchers who are relatively new in the field. An abridged contents page follows.

Abridged Contents of Monetary Frameworks in a Global Context

edited by Lavan Mahadeva and Gabriel Sterne

Part V: Specifying and Using Targets