
Executive summary of the single monetary policy in Stage 3

This is a summary⁽¹⁾ published by the European Monetary Institute (EMI) of its report on the alternative strategies for conduct of a single monetary policy by the European System of Central Banks (ESCB) in Stage 3 of Monetary Union. This follows the article (by David Rule of the Bank's Gilt-Edged and Money Markets Division) in the previous edition of the Quarterly Bulletin which gave the Bank's views on the EMI's proposals for the operational framework.

This report, which was prepared with the assistance of the EMI's Monetary Policy Sub-Committee, discusses issues related to the choice of a monetary policy strategy for the ESCB in the third stage of Monetary Union. The decision on the strategy for Stage 3 will have to be taken by the ESCB, in line with its independent status, on the basis of the economic environment and financial market structure prevailing in the euro area. Nevertheless, the EMI has an important role to play in preparing this decision by analysing possible strategies for the ESCB and by ensuring that the technical infrastructure needed for the efficient pursuit of monetary policy strategies is available as from the start of Stage 3.

The assessment of alternative monetary strategies should be guided by the general principles of effectiveness, accountability, transparency, medium-term orientation, continuity, and consistency with the independent status of the ESCB. Among these principles, effectiveness is of a more general nature, as the other principles can, in a way, be seen as contributing to the effectiveness of a strategy.

In the assessment of a strategy for the ESCB, the likely environment for monetary policy in Stage 3 and the specific situation at the start of Stage 3 will also have to be taken into account. One key feature of the ESCB's environment is that, due to the prospective size of the euro area and the fact that participating countries will trade to a significant extent with one another as evidenced by the high degree of intra-EU trade, exchange rate developments will most likely constitute less of a concern for the conduct of monetary policy than is currently the case for many individual national central banks. Furthermore, the ESCB will be confronted with a situation in which there will be structural differences across participating countries as well as cross-country differences in economic policies. A further important aspect, which is crucial for the choice among various monetary policy strategies, is the characteristics of the average monetary policy transmission process in the euro area. Yet, the uncertainty about the transmission process is also one of the main characteristics of the specific situation of the ESCB at the start of Stage 3. Further challenges for the ESCB arise from the fact that it will have no track record of its own at the start of its operations and that it will have to devise its

strategy taking into account the need for integration of new Member States into Monetary Union over time.

Several candidates for the ESCB's strategy have been examined by the EMI. For different reasons, it would not be advisable for the ESCB to pursue a strategy based on an exchange rate, interest rate or nominal GDP variable as an intermediate target. The analysis in this report therefore concentrates on only two strategies, namely monetary targeting and inflation targeting.

While pure forms of monetary and inflation targeting can be clearly distinguished at a theoretical level, their application in different countries has shown that several variants integrating elements of both strategies exist, with the borderlines between them sometimes being blurred. Common to both strategies is that they are based on the same final objective, price stability, that they are forward looking, and that they typically employ a wide range of indicators to assess the appropriateness of the stance of monetary policy. The main factor distinguishing the two strategies is the role played by monetary aggregates.

A detailed assessment of the two strategies against the guiding principles mentioned above and in light of the specific environment and the starting situation of the ESCB indicates that no unconditional recommendation can be given at this stage for the strategy of the ESCB. It can be argued that particular advantages of a monetary targeting strategy are that it clearly indicates a responsibility of the central bank for developments that are more directly under its control and that it can be interpreted by the public on the basis of observable information, in a transparent manner. In addition, monetary targeting would provide for continuity with regard to the strategy that was pursued by the anchor country in the ERM before the start of Stage 3. At the same time, it is recognised that the stability of money demand in the euro area is a crucial factor for determining the scope for monetary targeting. In this respect, stability of money demand is also important in guaranteeing that the ESCB actions can be confidently interpreted by the public as following a consistent scheme, thus ensuring that the strategy provides a clear anchor to

(1) Source: European Monetary Institute. Extract from the report 'The single monetary policy in Stage 3—Elements of the monetary policy strategy of the ESCB', published February 1997. Copies are available from the EMI Press Office: fax 49 69 2722 7404.

inflation expectations.

In fact, the uncertainty concerning the empirical properties of money demand in the euro area is the main argument against a monetary targeting strategy, as damage to the credibility of the ESCB could not be excluded if monetary aggregates turned out to be highly volatile at the start of, or during, Stage 3. With respect to an inflation targeting strategy, it is argued that this strategy directly stresses the responsibility of the ESCB for achieving and maintaining price stability. Furthermore, policy actions under such a strategy can be consistently and directly linked to prospective price behaviour, which, if the strategy is credible, will affect public expectations in a favourable way. It should be noted, however, that, to be successful, inflation targeting also requires stable relationships between various economic and financial indicators, on the one hand, and future inflation, on the other.

While there is no need to determine the precise details of the ESCB's strategy at this stage, five key elements can be identified that would be a useful part of any strategy of the ESCB. These elements should include, first, the public announcement of a quantified definition of the final objective of 'price stability'. Second, the ESCB should announce specific targets against which its performance can be assessed. Third, the ESCB should monitor a broad set of economic and financial indicators. Fourth, within these indicators, monetary aggregates should play a prominent role by publicly setting either target or monitoring ranges for their growth if money demand is sufficiently stable in the long-run. Fifth, the ESCB should be able, at least for the internal preparation of its policy decisions, to make its own forecasts for inflation and other economic variables.

The above elements can be combined in different ways. They would allow the ESCB the pursuit of both monetary and inflation targeting strategies and could also be used in

frameworks which put strong emphasis on monetary targets while using supplementary elements from inflation targeting strategies, or *vice versa*. Discussing all the options for combining key elements would be premature at this stage since their assessment will largely depend on the circumstances prevailing in Stage 3. It should rather be left to the ESCB to decide on the importance it wishes to attach to each of these key elements in the actual implementation of its policy.

In the implementation of a monetary policy strategy, there are many detailed issues on which the ESCB will have to take a decision. The main choices concern the precise identification of the target variable, the length of the target horizon, the width of the target range, and the response of the central bank to deviations from the target. Also crucial to the strategy is the communication with the general public. Finally, the ESCB will need to be equipped with the statistical and analytical infrastructure needed to provide guidance for the conduct of monetary policy.

In the remaining time before the establishment of the ESCB, the EMI will undertake further empirical research related to monetary policy strategy. Studies need to be undertaken on the area-wide monetary transmission process, on the properties of various variables as leading indicators for inflation, and on the properties of different monetary aggregates in terms of their stability, controllability and predictability. In view of the uncertainty about countries' membership in Monetary Union, these exercises will be conducted for different groupings of EU Member States. Furthermore, these exercises will also consider the likely impact of EMU on the empirical relationships. The EMI will also study, prior to the establishment of the ESCB, certain implementation aspects arising for the ESCB in the case of the entry of additional countries into Monetary Union after the start of Stage 3.