Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

Economic Unit

15th September 1993

THE IMPLICATIONS OF WIDER ERM BANDS FOR MONETARY CO-ORDINATION

- Issues for Discussion -

The recent turmoil in European foreign exchange markets, which was followed by a general widening of the ERM bands to 15%, has marked a major change in the framework for monetary policy in the EC. There is now scope for more flexibility in exchange rates, thus in principle allowing monetary policy to focus more on internal objectives, if so desired. The range of monetary indicators and the approach to fiscal policy may also need to be reconsidered. These developments clearly have major implications for the co-ordination framework in general and for the forthcoming ex-ante exercise in particular. This note accordingly seeks to raise conceptual and policy issues which the sub-committee may wish to discuss.

1. The decision to *widen the ERM fluctuation margins* (see Chart 1) has two important effects: on the one hand, the possibility of larger exchange rate movements has increased the scope for policy differentiation among ERM countries. On the other hand, the widening of the bands in the wake of the recent crisis is likely to have reduced credibility, and markets may seek compensation for the increased exchange rate risk in the form of higher interest rate premia. (Recent data for nominal rates and differentials with the DM are shown in Charts 2 and 3.)

To what extent are wider bands seen to have increased *in practice* the room for differentiated policies among ERM countries? In particular, have constraints been eased to a different degree in individual countries?

2. The new circumstances entail certain *risks*. In the absence of the narrow margins of the former ERM, there is a danger that "aggressive" reductions in interest rates, in the pursuit of economic recovery, could lead in the short term to competitive depreciation of exchange rates, and in the long term pose dangers for inflation. Competitive depreciation would also clearly reduce convergence itself and could endanger the functioning of the Single Market. Furthermore, speculative pressures cannot be ruled out if currencies approach the bottom of the band. Finally, there may be a tendency for overshooting of exchange rates, which could lead to protracted misalignments of real exchange rates and hence misallocation of resources.

How serious are these risks? To what extent should the available room for differentiating interest rate conditions be used in different countries, in the light of the above risks?

3. The commitment to exchange rate stability has represented a very important element in the *setting of national monetary policies* in the Community during past years. However, if the recent adoption of wider ERM bands implies a reduced emphasis on the maintenance of exchange rate stability, or at least a less precise definition of this objective in the short run, greater importance may have to be given to alternative indicators of the stance of monetary policy. The choice of these indicators may depend on differences in country size and national customs in the formulation and implementation of monetary policy. Monetary aggregates are the obvious example, but indicators such as yield spreads and asset prices could also have a role to play.

In the present circumstances, which variables (intermediate or final) should guide the authorities in determining the stance of national monetary policy? What additional indicators could be useful in assessing monetary policy?

4. As regards *fiscal policy and the policy mix*, the new environment is seen in some quarters as increasing the need for rapid progress towards fiscal consolidation, given the adverse effect of loose fiscal policy on inflation expectations, particularly as policy credibility may be weakened by the widening of bands. Furthermore, the costs of fiscal consolidation may be seen as smaller and thus more acceptable given the weaker short-term contractionary effects on domestic economic activity that may result from external crowding-in following exchange rate movements.

Has the appropriate policy mix changed in the light of recent developments? Given the larger spillover effects that are now to be expected, what are the implications for monetary policy if fiscal consolidation takes place in an unco-ordinated fashion?

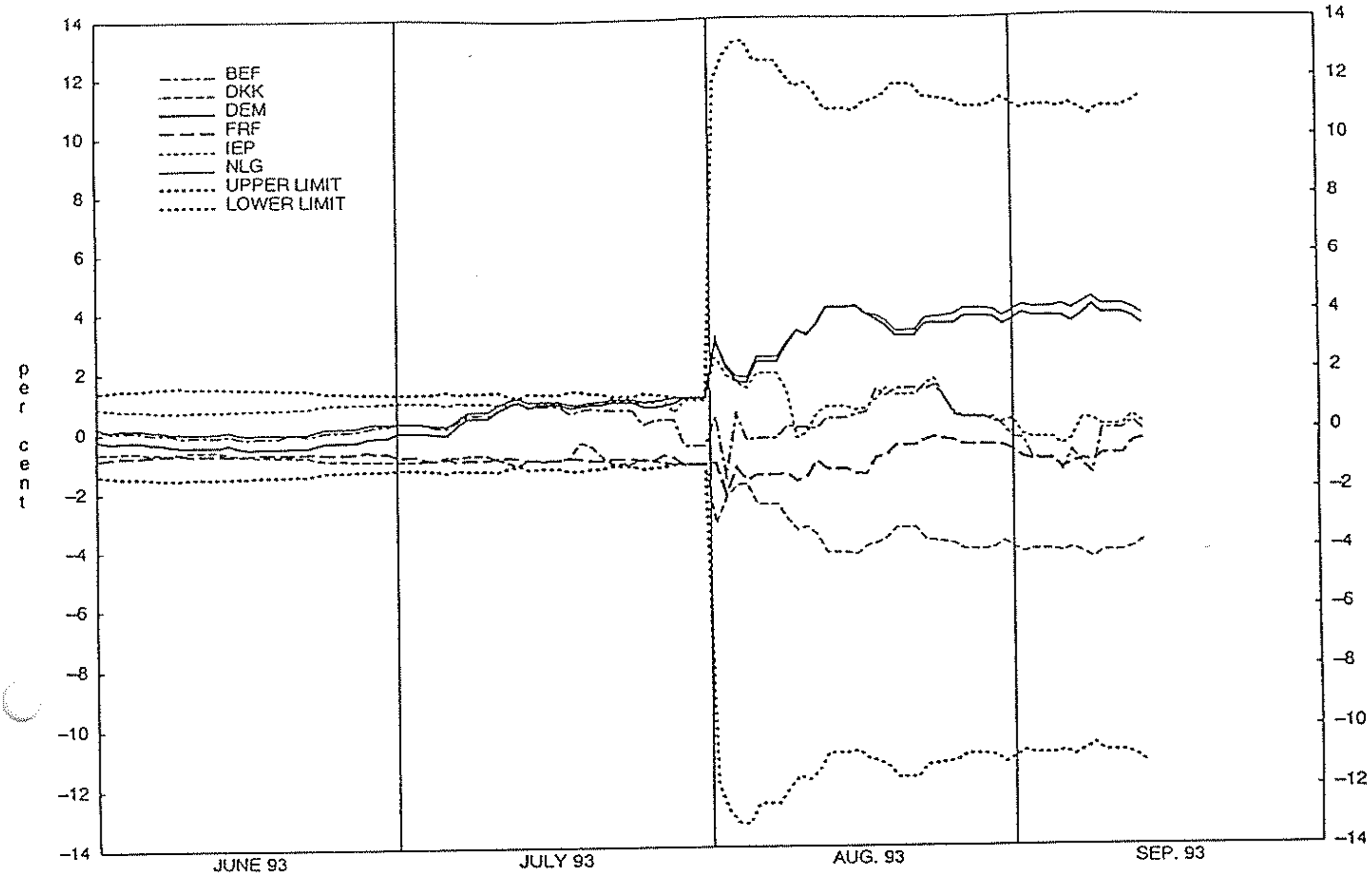
5. For some time now it has been recognised that, in an environment of free capital movements and financially integrated markets, exchange rate stability can only be sustained if underpinned by an effective co-ordination of macroeconomic policies. In past co-ordination exercises, the *"mutual compatibility"* of monetary policies in Community countries has traditionally been assessed on the basis of whether policies were in line with the objective of moving towards price stability without giving rise to major exchange rate tensions. If the role played by exchange rate constraints in the co-ordination of national monetary policies is reduced, the framework for co-ordination may have to be reassessed.

In the context of wider ERM bands, does the above notion of mutual compatibility continue to be useful in the co-ordination exercise? If not, what criteria should be used to evaluate the mutual compatibility of policies?

6. In this context, prior to the ERM crisis, the broad concept of the *"overall stance of monetary policy in the EC"*, was based on the fact that countries were adopting similar policies in maintaining their currencies within the ERM bands. This concept may now need to be modified, particularly if countries begin to put greater weight on domestic factors in setting their monetary policies.

Do delegates consider the concept of the overall stance of monetary policy prevailing prior to the crisis still to be relevant? If not, in what ways do they consider it should be modified?

Chart 1a. POSITIONS WITHIN THE EMS : NARROW BAND (*)

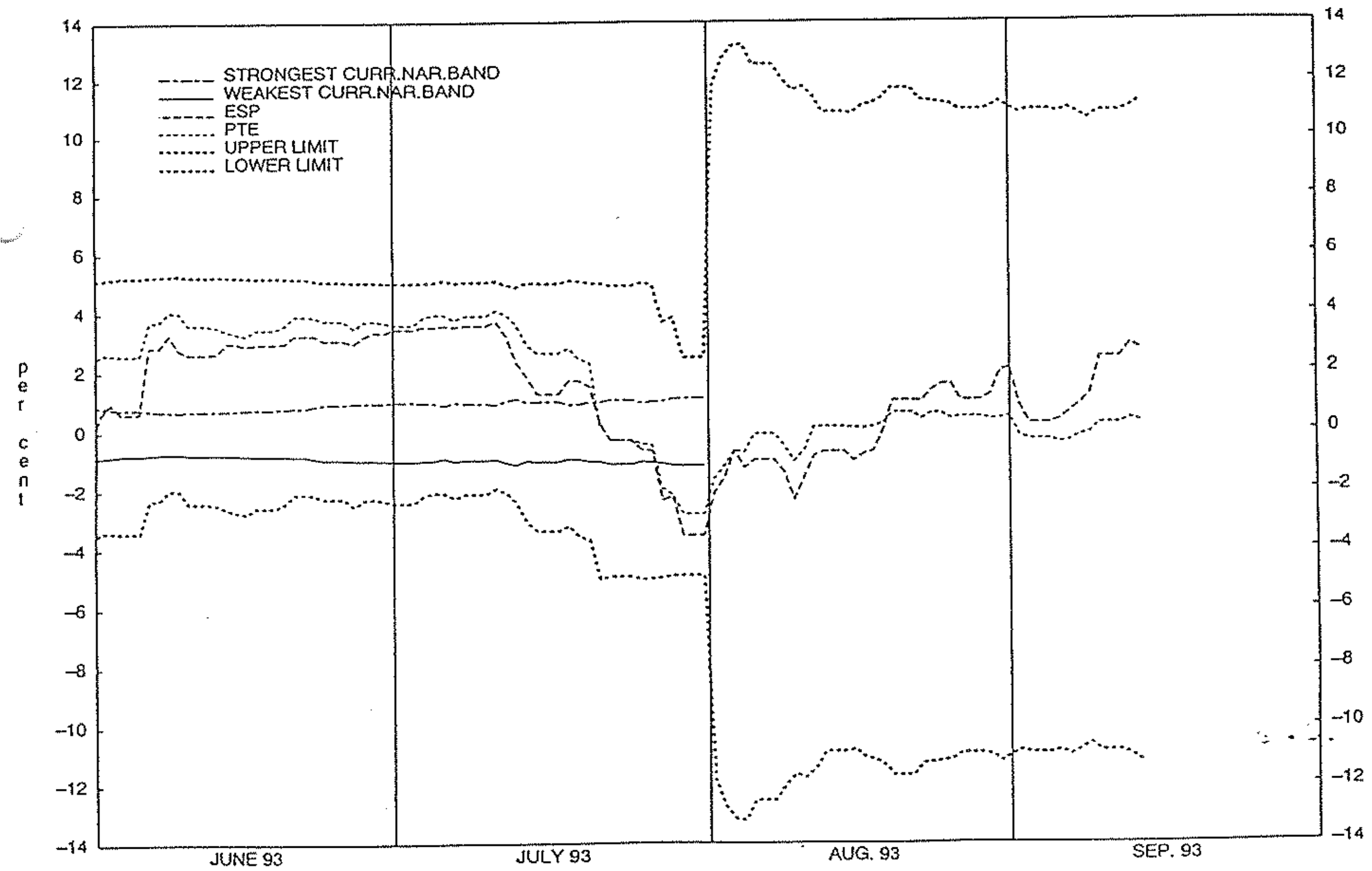


(*) Effective 2nd August the ERM fluctuation margins have temporarily been increased to (+/-) 15 per cent.

1.

EEC SECRETARIAT

Chart 1b. POSITIONS WITHIN THE EMS : WIDE BAND (*)

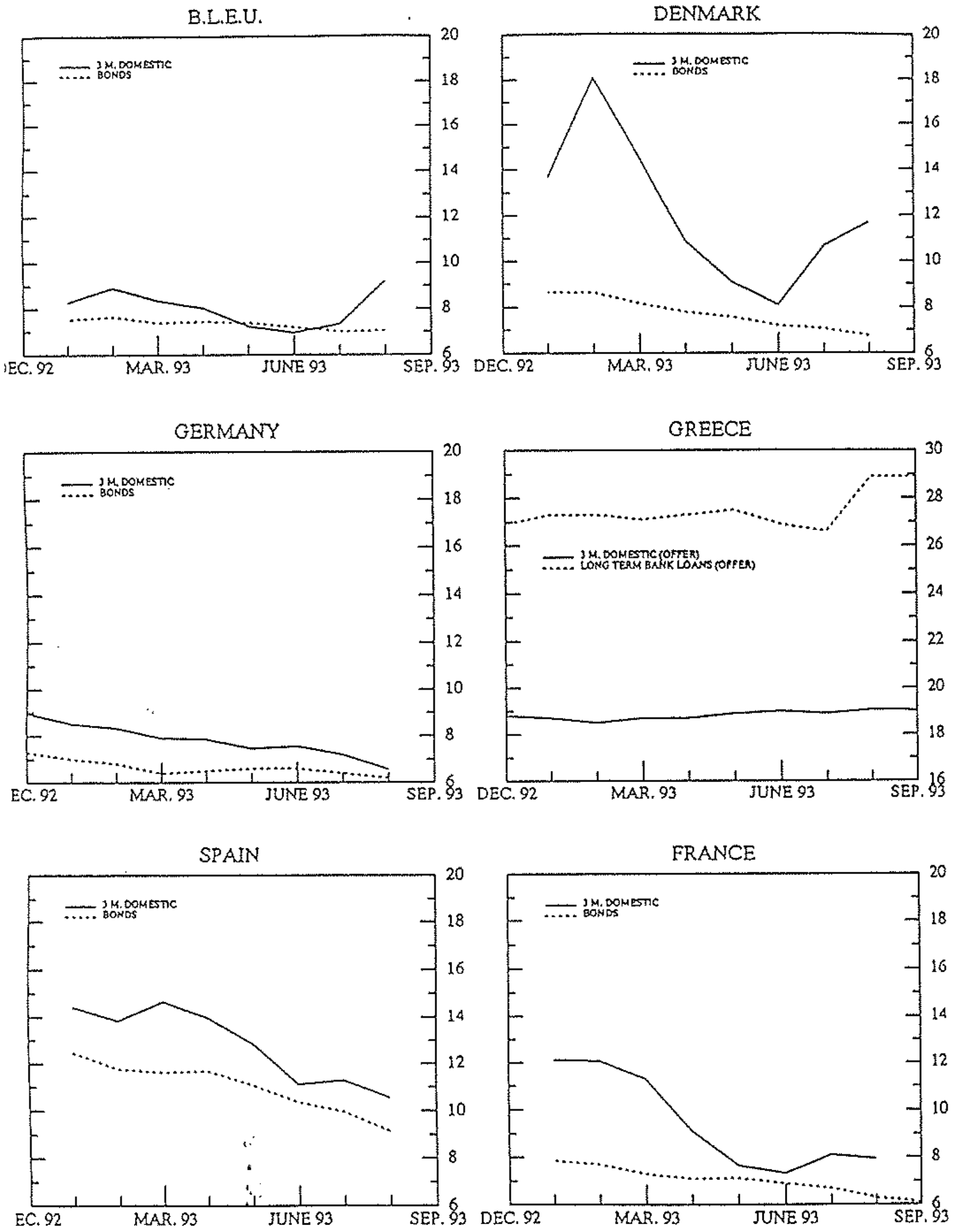


(*) Effective 14th May, the bilateral central rates of the ESP and the PTE vis-a-vis the other ERM currencies were reduced by 8 per cent and 6.5 per cent respectively. Effective 2nd Aug. the ERM fluctuation margins have temporarily been increased to (+/-)15 per cent.

2.

Chart 2.

NOMINAL INTEREST RATES



NOMINAL INTEREST RATES

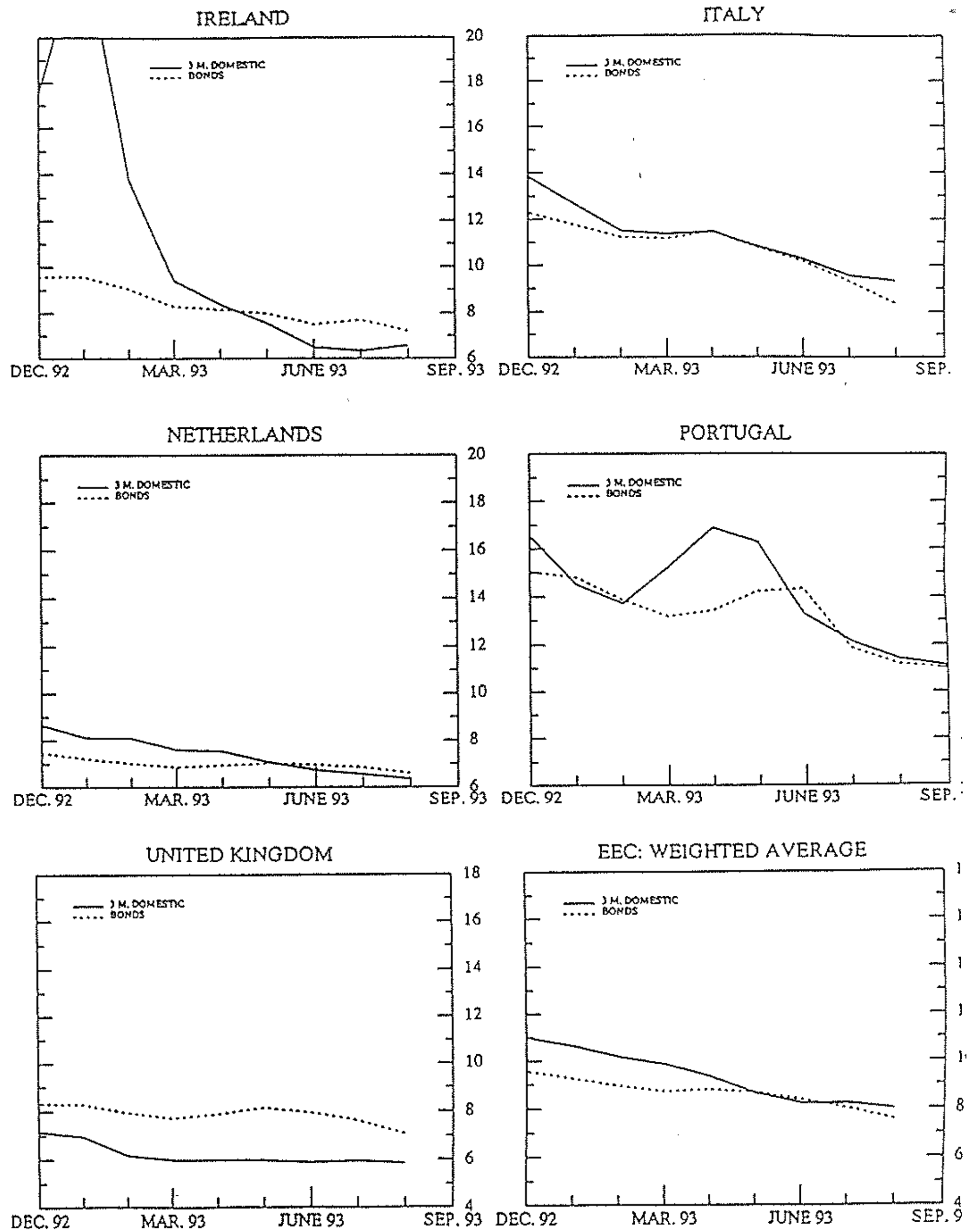


Chart 3. INTEREST RATE DIFFERENTIALS WITH GERMANY
(monthly average)