

Commentary: Monetary Policy and the Control of Inflation

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As the other commentators have said, Governor Crow's paper deals in an appealing and balanced way with most of the issues and options in monetary policy and the control of inflation in emerging market economies. I shall focus my remarks on one central issue on which he invites comments from the panel of East European central bankers and the appointed discussants: namely, the relative merits of external versus domestic objectives in designing a stability-oriented monetary policy. That topic has, of course, also been addressed by several other commentators. But since I am the only discussant from a member state of the European Economic Community, I may be forgiven for referring to the experience of countries in that Community with respect to their efforts to create monetary stability through the exchange rate and, more recently, to move toward economic and monetary union. I also want to come back, at the end of my comments, to the remarks of Governor Crow on the importance of having a diversified range of instruments in each economy.

Governor Crow rightly sees the crucial virtue—in the promise of early credibility—that an external orientation of monetary policy, one with a fixed nominal exchange rate against a major international currency with a good international record, would bring. But it is obvious from the subsequent discussion that he has serious reservations about proposing a policy which has stability, in this sense, as the main focus. So he does not completely, I think as he said he

intended to, refrain from giving odds for the different horses that he parades in front of us, the external and the internal way of formulating policy.

He asks two critical questions that are obviously relevant to this choice. The first is: would the East Europeans not have to go all the way to a monetary union, participation in an area with a single European currency, to achieve full benefits in terms of disciplining domestic costs and prices? But, as he says, monetary unions—EMS-type arrangements for convergence—look a fair way off at this point. So this is a negative verdict against the external anchor.

The second question is: would the East Europeans not find it potentially very costly, in terms of output and employment losses, to forsake flexibility of the nominal exchange rate at a time when "relative prices will move probably to a great extent under the impact of market transformation requiring real exchange rate changes"?

These two questions are clearly of decisive importance for the weight one can assign, maybe after a short transition period, to pegging the nominal exchange rate as a centerpiece of an anti-inflationary strategy. If the answer to these two questions put by Governor Crow were a confident yes, then the East Europeans would be well advised to proceed to the subsequent parts of his paper and look at the domestic options for a stability-oriented policy. But the answers appear to me to be less unequivocally yes to the two critical questions. And if so, the market-oriented economies in Eastern Europe might, with some benefit, make an explicit commitment to peg the nominal exchange rate a central element in their strategy.

Let me try to take up the two critical questions he raised. In a sense, the first question—whether one has to go to full irrevocably fixed exchange rates or even full monetary union to deliver credibility—captures well the discussion within the European Community in the last couple of years. Full monetary union clearly has a political as well as an economic inspiration. But the major economic argument for full monetary union, moving through fixed rates toward a single currency, is that only the final stage would yield the full benefits in

terms of unification of markets and full credibility of the commitment. It is observed that inflation rates within the European Economic Community have not converged fully, although good progress has been made over the last couple of years. Furthermore, interest rate differentials persist between national markets because the commitment to exchange-rate fixity is not complete. Hence, it is argued there is no substitute for full monetary unification to achieve the full benefits through external credibility.

What this argument overlooks, I think, is the contribution that intermediate types of commitments may make to low inflation performance, and have, indeed, made within Western Europe. The fixed but adjustable rate system that we had operated in the European Monetary System, first with some flexibility from 1979 to 1983 and then with increasing rigidity since 1983, has in fact implied a very considerable degree of inflation control and convergence toward a low level of inflation, such as we have observed in the lowest inflation countries in the Community. And remember, that policy was not explicitly announced.

If one adds to this picture the experience of those countries in Western Europe that did not undertake similar commitments, with their difficulties in controlling the inflation rate, I think one would arrive at a somewhat more favorable verdict on the possibility of achieving a considerable degree of inflation control without full monetary unification.

What about the output and employment costs of a fairly rigid nominal exchange rate? **Allan** Meltzer and Georg Rich both stress the different ranges of ambition in moving toward monetary union. What Governor Crow dismisses, I take it, is only the full monetary union of the German type that we have just seen. That would indeed require such a large number of very rapid and substantial adjustments as to make it unrealistic for other economies in Central and Eastern Europe. But I trust he would not imply that pegging unilaterally, but firmly, to a currency standard of their main trading partners in Western Europe would in itself be an unfeasible strategy for them, nor that it would not help considerably in achieving inflation control.

It seems to me to be, with currency convertibility for current account transactions, an essential step.

If the recent experience of Western Europe is not seen as sufficiently relevant because these economies have already been closely integrating for a number of years, one might look back to the long period of the 1950s and 1960s in Europe, where exchange rates were stable, and expected to remain so, within the framework of the **Bretton Woods System**. That also led to a period of fairly stable, and modest, inflation and rapid growth in the Western European economies. If you want to look still further around to evaluate the answer to the second question that Governor Crow raises about the costs of fixed exchange rates, I think his argument may underestimate the degree of flexibility you can have in relative prices and in the real exchange rate without moving the nominal exchange rates. We have examples elsewhere in the world economy: from East Asia and Japan, with long periods of exchange rate stability prior to the **1970s**, which nevertheless left very considerable scope for real exchange rate changes—improvements in competitiveness in some periods, real appreciation in others, in their case, as one would hope would be the case for a long time for the Eastern European economies. So I think, on the second point, the costs of fixing exchange rates, as put forth by Governor Crow, may be exaggerated on the negative side.

Let me turn briefly to the other element, namely his emphasis on the range of instruments available. I share fully his views that the development of market-oriented instruments is essential to the success of monetary policy, for the reasons he gives and for the additional reason that they increase the independence of the central bank in managing monetary policy. That applies to the management of government debt, in particular. But I think he may overlook that there are other instruments in monetary policy that could be used profitably which are not quite of the market-oriented type, such as reserve requirement changes and discount rate changes, which Eastern European economies should not easily give up.

Finally, in the context of the discussion of economic and monetary union in the European Communities, the emphasis has been on two

main aspects. First, that the central bank, in a common monetary union, should be devoted to price stability—have that as its overriding objective. And second, that it should be independent of political instructions. I think that there is an interdependence between these two elements. Price stability is difficult to achieve without having considerable independence for the central bank. But independence of the central bank is also difficult to conceive unless one confines the task of the central bank fairly narrowly to that of price stability. If the central bank has to participate in all sorts of government activities—for example, in financing budget deficits, and in the formulation of other policies—then it becomes difficult to avoid the kind of political involvement in monetary policy that we are trying to move out of gradually in the European Communities.