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DEUTSCHE BUNDESBANK

DER PRÄSIDENT

FRANKFURT AM MAIN, August 21, 1989

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Mr. Erik Hoffmeyer
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Thank you for your letter of July 28, in which you suggested enhanced monetary policy monitoring in the EC on the basis of monetary aggregates. I am basically in favour of this suggestion, for monetary targets seem to me in fact to be a good approach to a credible anti-inflationary policy - also at the European level. But there are nonetheless some very difficult substantial questions to be faced.

The first question is whether commonly agreed national monetary targets should be used or whether a single monetary target should be formulated for the EC (or - as you also suggest - its core countries) as a whole.

In the first case - jointly discussed or agreed national monetary targets - it would be necessary to agree on the common "superordinate" target, viz. price stability. This superordinate target should be based on national price stabilisation targets, which lead to convergence in the field of price stability, i.e. in practice aim at a zero or near-zero inflation rate rather than at average inflation rates.

-2-

In addition, each country should consider its medium-term real growth potential when setting the monetary target. Depending on the development stage, demographic and other supply-side determinants, this potential may differ in size. Account would also have to be taken of the medium-term behaviour of the velocity of circulation of money. And finally, each country would choose as the target variable that monetary aggregate which comes closest to the money stock "relevant" to it, i.e. which has a close correlation with aggregate demand and, as experience has shown, responds best to monetary policy action.

As we all know, there is to date no money stock definition (monetary base, M1, M2, M3) which would be equally relevant to all EC countries. The individual monetary aggregates differ from country to country with respect to their longer-term stability properties (relation to GNP, to the price level, etc.), their controllability, signalling effect vis-à-vis the general public, etc. We therefore cannot be sure that a search for the best indicator for each country will lead to an aggregate defined in the same way; the opposite will probably be the case.

The alternative would therefore be to set a single monetary target for the EC (or the core countries). It seems to me that for the time being this would pose considerable problems. There is in fact no such thing as an "EC money stock". There are only national and - rightly - different money stock definitions. Hence for the time being the EC money stock would be an artificial aggregate, whose magnitude would moreover change upon realignments of EC exchange rates.

And there would be yet another problem. As long as national monetary targets are set, it is correct to assume that - to a greater extent in one country, to a lesser extent in another - the monetary authorities are in a position to manage the money stock so as to keep it on target, in order to achieve the superordinate objective of price stability (and growth that is in line with potential). If a monetary target were set for the EC with the same economic policy objectives, this would have to be true here too. I very much doubt, however, whether the monetary structures in our countries have developed and converged to such an extent that any such attempt would have a good chance of success. This would have to be the case, however, in order to ensure that the whole exercise is not discredited immediately.

To date, some countries are reluctant to gear their monetary policy primarily to a money stock indicator as they do not believe that this would contribute to an optimum achievement of the ultimate economic policy goals. In fact, things are different for large countries and small ones. The latter may prefer to use the exchange rate vis-à-vis the most stable currency as a guideline - a policy which obviously can yield quite satisfactory results.

In the light of the experience of the last few years, the large countries, too, are faced with the question of how their monetary policy should respond to shocks caused by international capital transactions, in particular if there were to be no further exchange rate adjustments in the EC. Much as I basically favour your suggestion, I consider it advisable to carry out in-depth research before the monitoring system you propose can be put in place in a generally acceptable form.

With best regards,