

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

MASTER FILES

ROOM C-120

01

SM/86/48  
Correction 1

CONTAINS CONFIDENTIAL  
INFORMATION

March 19, 1986

To: Members of the Executive Board  
From: The Secretary  
Subject: World Economic Outlook - Supplementary Notes

The following correction has been made in SM/86/48 (3/3/86):

Page 25, footnote 1, last line: for "(SM/86/ )."  
read "(SM/86/49, Supplement 3)."

A corrected page is attached.

Att: (1)

Other Distribution:  
Department Heads

Supplementary Note 2

Monetary Developments in Major Industrial Countries

1. Introduction

During the past decade, a number of major industrial countries specified target ranges for the growth of key monetary aggregates as part of a medium term policy framework that gave special emphasis to controlling inflation. These monetary targets have played an important role in establishing the credibility of the authorities' commitment to anti-inflation policy and have thereby increased the policy's effectiveness. Partly as a result of these policies, the average rate of inflation (as measured by the GNP deflators) in the major industrial countries has declined from over 9 percent in 1980 to 3.5 percent in 1985. This represents the lowest average rate of inflation in these industrial countries since 1967.

While the period since 1980 has witnessed a decline in inflation in all major countries, the implementation of policies involving monetary aggregates targeting has faced a number of difficulties. The substantial changes in exchange rates, nominal and real interest rates, and financial market structures that occurred in the early 1980s made it difficult for the authorities in some countries to control and to interpret movements in monetary aggregates. These developments also complicated the operational problems associated with the conduct of monetary policy by introducing increased variability into the relationships between the growth rates of monetary aggregates and the expansion of nominal income. The extent and nature of this variability has differed across countries. The velocities of some key monetary aggregates have oscillated over a wider range than previously experienced while showing no clear trend (e.g., the income velocity of M2 in the United States), whereas the velocities of certain other key aggregates have shifted trend in a reversal of previous behavior (e.g., the income velocity of M3 in the United Kingdom).

In some cases, central banks have specified their targets without being able to predict the sharp movements in velocity that would occur during the target year, especially when market innovations or changes in regulations led to the creation of new types of financial instruments. <sup>1/</sup> Changes in financial market regulations generally tended to increase the velocity of narrow monetary aggregates, which usually include a relatively

---

<sup>1/</sup> The behavior of velocity and its implications for policy are explored in the background staff study "The Velocity of Money and the Practice of Monetary Targeting: Empirical Experience and Theoretical Foundations" (SM/86/49, Supplement 3).

high proportion of assets with controlled interest rates; <sup>1/</sup> whereas the velocity of more broadly defined aggregates did not change as substantially. To a considerable extent, the pressures that gave rise to financial deregulation resulted from the rapid growth of new forms of financial instruments with market-related yields, which in turn reflected the strong incentives for the public to reduce its holdings of instruments with fixed or controlled yields in a period of high market interest rates.

The uncertainties surrounding the nature and stability of the linkages between the monetary authorities' policy instruments, their intermediate monetary targets, and their overall macroeconomic objectives have affected both the priority given to achieving monetary targets and the range of economic and financial variables used by the authorities in evaluating monetary conditions. As a result of these uncertainties, the growth rates of monetary aggregates have in a number of cases been allowed to move outside their target ranges. In some cases, target ranges have been modified prior to the end of the original target period and, in certain countries, the new bases that have been set for the monetary targets have incorporated the overshooting of the target ranges in the previous period. Several countries have established target ranges for more than one aggregate simultaneously, and in some cases the targeting of particular monetary aggregates has been de-emphasized or abandoned.

Of course, the monetary authorities in the major industrial countries have for some time examined a broad range of indicators of economic activity and financial market developments in evaluating monetary conditions. Nevertheless, the general decline in inflation and the instability of the linkages between money and income in some countries have led some authorities to give relatively more weight than previously to movements in such variables as the exchange rate, interest rates, and nominal or real income. The behavior of monetary aggregates relative to their targets nonetheless remains an important consideration in the formulation of policy in most major countries. However, the renewed focus on short term movements in exchange rates, interest rates, output, and employment raises issues concerning the extent to which the authorities can pursue these objectives through monetary policy without jeopardizing the credibility of their long-term commitment to an anti-inflation policy.

In what follows, recent monetary policy in the major industrial countries is examined in Section 2. The first part of this section considers developments in these countries as a group while the second contains notes on individual countries' experience. Section 3 of the paper examines prospects for 1986.

---

<sup>1/</sup> Where the narrow aggregates also include new financial instruments, however, velocity has tended to decline to the extent that these new instruments have been attractive substitutes for deposits not included in the narrow aggregates.