

# Italian Monetary Policy in the '80s and '90s: The Revision of the *Modus Operandi* \*

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## 1. Introduction

On 16 September 1992, overwhelmed by speculative pressures, the lack of effective coordination among European Community member countries and its own outdated economic policy, Italy was forced to suspend the lira's participation in the EMS Exchange Rate Mechanism.

The third anniversary of this ill-omened event may be a suitable occasion for reflection on the structural changes that have taken place since that crucial passage in the recent economic history of our country. However, the field for reflection is vast indeed, ranging as it does from the financial to the economic, from banking to monetary policy.

The present article restricts the field to monetary policy alone. Using a well-established technique (Tinbergen 1952), we analyze objectives and instruments separately. The former represent the goals – either final, and thus socially desirable, or else intermediate, provided they are technically achievable – that the central bank seeks to attain by using the variables and operative procedures under its direct

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control. The presentation of the objectives here is stylized, with no thorough discussion of their merits; that of the instruments lacks an examination of the mechanisms of transmission. Nevertheless, the account will not be brief, because in fact the *modus operandi* of Italian monetary policy in the '80s and '90s was radically transformed.

The heart of monetary policy, like all policies, is the relationship of instruments to objectives. In complex, globalized markets, the path from the operative levers to the objectives is made broader and more uncertain by a multiplicity of factors: unexpected shocks, imperfect information and lags in transmission, temporal inconsistencies and strategic interdependence.

Other things being equal, the removal of the intermediate anchor represented by the lira's participation in the Exchange Rate Mechanism (ERM) arrangements has made navigation from instruments to objectives less easy and, inevitably, less transparent. Managing a controlled float, in any case, tends to shift the emphasis of monetary policy analysis from the linkage between instruments and objectives to the central issue of the task of the central bank as such, its structure and the institutional framework for its action.

In this sense the suspension of the lira's participation in the ERM has thrown the shortcomings and anomalies of the Italian situation into sharper relief. Unlike Germany's fundamental law, which assigns the central bank the task of defending the value of money, the Constitution of the Italian Republic, admirable in so many ways, says merely (Article 47) that "The Republic shall encourage and protect saving in all its forms; it shall regulate, coordinate and monitor the exercise of credit".<sup>1</sup> Not only is there no indication of the organ charged with these duties; it is not even clear, at a glance, whether the protection accorded saving refers to nominal value or real value.

It was only with the Treaty of Maastricht on Economic and Monetary Union that the Italian Parliament, called like the other national parliaments and the European Parliament to its ratification, began to deal with the fundamental questions of what purpose monetary government is to serve and who is to be responsible for it (Title VI, Chapters 2 and 3, Articles 105 *et seqq.*). Thus the ratifi-

<sup>1</sup> Essentially, this simply rehearses the substance of the repealed Banking Law of 1936, Article 1, which reads: "The taking of savings from the public in any form and the exercise of credit are functions of public interest ...".

cation of the Treaty and preparation for eventual membership in the Monetary Union lent renewed impetus in Italy to the affirmation of the central bank as an independent authority accountable to public opinion and committed to the achievement of stability (Padoa-Schioppa 1995). First of all stability should consist in the abatement of uncertainty concerning the present and future value of money, or its price in terms of other currencies (the exchange rate), in terms of goods (inflation), and in terms of itself (interest rates). Under this interpretation – or, to be exact, construction – of our monetary constitution, the "protection of savings" mandated by the Constitution takes on a much more precise and incisive meaning. Yet one cannot help but observe that this interpretation, while authoritative, is based on a manner of sensing and handling the responsibilities of the central bank; that is, it is based on practice, not on a formal constitutional or legal precept.

## 2. Policy objectives

### 2.1. *The exchange rate*

From 1979 to 1992 Italy participated in the European Monetary System's ERM. For thirteen years the anchoring of the lira – although attenuated by a succession of seven realignments of the lira's central rate within the EMS, five of them prior to 1987 – served as an intermediate objective on the path to the ultimate goal of disinflation. From peaks of over 20 percent at the start of the '80s, the yearly rate of consumer price inflation dropped steadily to 6 percent in 1986, finally stabilizing at 5 percent in 1992.

Some dissenting voices have been heard (Fратиanni and von Hagen 1990), but in general there is very broad agreement (CER 1995, Visco 1995, Padoa-Schioppa 1995) on the important role that was played by the semi-fixed exchange rate as an intermediate means of disciplining market expectations and initiating the lengthy process of building up the anti-inflationary credibility of economic policymakers. Tangible evidence of effective stabilization in this period is offered by the interest rate differential between Italian and German government bonds, which was cut from 10 points at the turn of the '80s to 5 or 6 points between 1987 and 1991.

The anchoring of the exchange rate of the lira gained additional credibility thanks to a five-year stretch with no realignments, the application of the narrow 2.25-percent fluctuation band, and the full liberalization of capital movements. And since monetary policy was used to sustain a stable nominal exchange rate, it is understandable that the ratification of the Maastricht Treaty should have fostered the illusion of a quick passage to Monetary Union.

Italy's higher inflation rate necessitated higher interest rates, eventually attracting large-scale inflows of short-term capital investment, quick to take advantage of a yield differential that was not offset by a countervailing exchange rate risk. This meant an accumulation of foreign exchange reserves and at times a downward pressure on interest rates that was not consistent with the fight against inflation. Given the exchange rate constraint, therefore, the monetary policy stance could not be tightened further to squeeze out inflation without at least temporarily aggravating the capital inflow.<sup>2</sup> Revaluation would have worsened the current payments imbalance and dealt a further blow to Italian exports, already suffering from the rise in the real exchange rate.<sup>3</sup>

The conclusion is the classical one: to be effective against chronic high inflation, monetary policy must impose very high social costs, which are hard to make people bear, especially when the mandate to ensure monetary stability is lacking or uncertain. Otherwise, monetary policy must be flanked by consistent fiscal policy and incomes policy. In Italy's case, the latter two were late in arriving, and instead we had "Black Wednesday" in September 1992. Yet even if the exchange rate proved not to be the fixed point of reference that, by itself, could lead to the complete and irreversible transformation of the monetary regime (see below), anchoring to it did to some extent alter the behaviour of economic agents and allowed the central bank to achieve monetary stability in at least one acceptance of the term: as the exchange rate is one of the prices of money, its stability can be viewed as a sort of quasi-final objective as well as an inter-

<sup>2</sup> On the conflict that emerged during the period of the "new" EMS (1987-1992) between the exchange rate target and the control of domestic interest rates, see Giavazzi and Spaventa 1990.

<sup>3</sup> From 1987 to 1991 the rise in the real effective exchange rate of the lira, on the basis of unit labour costs, represented an 11.8 percent loss in competitiveness. Over the next three years, 1992-1994, the rate moved in the opposite direction, and nearly twice as far (a depreciation of 23.4 percent).

mediate objective against inflation, which the issuing central bank must pursue if the scenario is one of monetary union (Sarcinelli 1986).

Paradoxically, the end of the exchange rate constraint served to complete the anti-inflationary policy turn. The removal of wage indexation, fully accomplished in July 1992 under the government of Giuliano Amato, was accompanied by the long-sought primary budget surplus (net of interest payments), another of Amato's achievements. The realization of this "virtuous passing of the torch" from the exchange rate objective to the commencement of sound, solid incomes policy made no small contribution over the next few years to mitigating the pernicious effects of abandoning the EMS anchor. Equally decisive in curbing the inflationary fallout of delinking the lira was the Italian and European recession of 1992-1993.

For Italy, the period following exit from the ERM showed the best inflation performance in 25 years: 4.5 percent in 1993, 3.9 percent in 1994. These results are extraordinary considering that over these two years the lira suffered a depreciation of about 25 percent against the Deutsche Mark and against a weighted average of the currencies of Italy's main trading partners.

However, it would be rash to take these elementary facts as evidence that the inflationary risk of protracted devaluation has somehow been defused. Rather, the apparent paradox of 1993-1994 – declining inflation and a continually depreciating lira – prompts reflection on the possible further deceleration of consumer prices that the maintenance of the exchange rate objective might have achieved, other things being equal. A counterfactual exercise (Locarno and Rossi 1995) concluded that had the exchange rate remained constant from the third quarter of 1992 to the end of 1993, Italian inflation would have been practically cut to zero.

Exchange rate instability therefore represents a cost to the country's welfare. In the same way, the absence of a formal anchor for the currency is no trifling matter in an economy marked by international openness. The key point for monetary policy, however, is a different one. As the crisis of 1992 makes clear, in isolation the exchange rate objective is unsustainable. The lira was forced out of the ERM when it became impossible to sustain a situation in which the rigid exchange constraint had to compensate for tendencies in other key determinants of inflation that were not, or not sufficiently, stability-oriented.

The gains made on the incomes policy front – certainly not irreversible – might warrant a less sceptical view of future reestablishment of exchange rate stability as an Italian monetary policy objective, on condition that there be no irresolution on the continuing rehabilitation of the public finances, whose improvement is now incontrovertible. The credible restoration of an exchange rate anchor would require not only observance of these internal conditions but also the realization at Community level of improved coordination of monetary and economic policies.

Only in these terms, in a framework of coordination of intermediate objectives (exchange rate, growth of incomes, budget deficit) and closer international cooperation, could the prospect of re-entry into the EMS serve in lasting fashion to consolidate the restoration of the exchange rate constraint, diminish inflationary expectations and facilitate the narrowing of interest rate differentials (Figure 1).

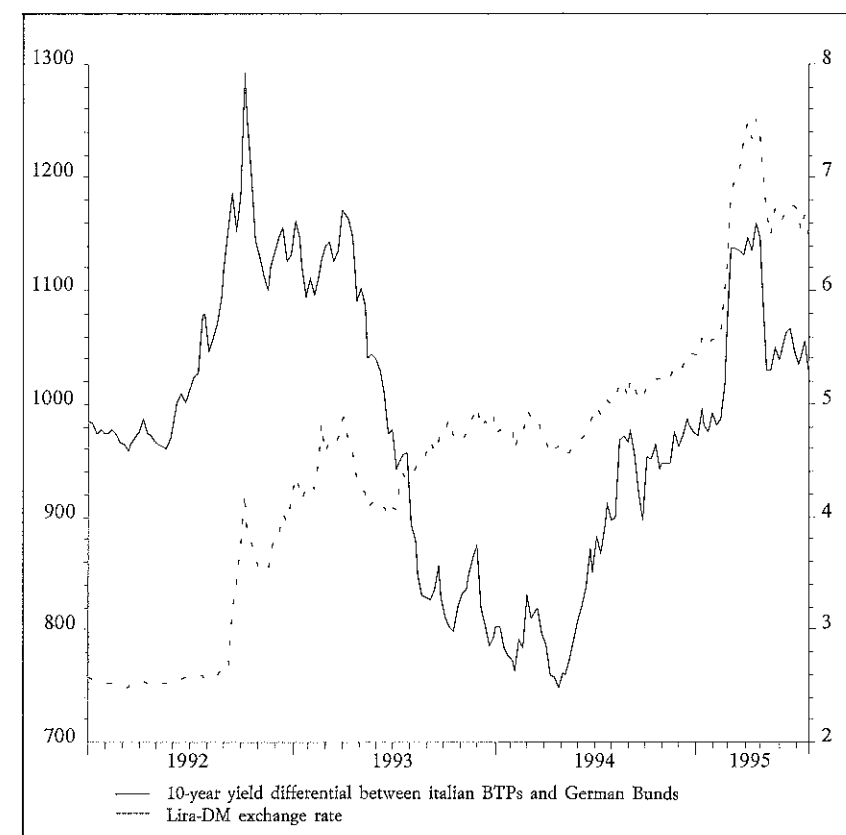
## 2.2. The money supply

In the transition from a regime of semi-fixed exchange rates to the free float of the lira, one element of continuity in the central bank's conduct has been the setting of target ranges for the growth of M2. Superficially, this common denominator between the situation before and after the abandonment of the EMS may seem questionable, especially in view of the uneasy coexistence of money supply targets with the exchange rate anchor during the ERM years.

Under a semi-fixed exchange rate, the growth of the money supply becomes largely endogenous and accordingly hard to control, considering the high cost – in the form of excessive volatility of interest rates – of continuous, timely sterilization of changes in the external monetary base. It has been lucidly observed (Spaventa 1995) that from 1988 to 1991 Italian monetary policy proceeded with “an intermediate objective and a half” – the exchange rate and, insofar as it was consistent with this, the money supply. Of course one can always set money supply values consistent with the actual exchange rate targets, but it is doubtful whether setting a target that is such only in form, not in substance, is any help in understanding the gist of the monetary policy the central bank intends to pursue. The transparency about which such a fuss is made is certainly not enhanced.

FIGURE 1

LIRA-DM EXCHANGE RATE AND 10-YEAR BTP-BUND YIELD DIFFERENTIAL



Source: DATASTREAM.

Some confirmation of the validity of this interpretative framework is offered by the less than brilliant performance of the money supply targets from 1988 to 1991 (Table 1). In just one of those four years did actual growth fall within the target range, though it also came close more than once. Perhaps the objectives were not ambitious enough; perhaps the width of the range was kept unchanged for years on end, not taking previous gains into account.

Other things being equal, leaving the EMS enhances the attainability of the money supply target. Given the same ratio of supply to demand for the currency, now not only the quantity (the flow of

TABLE 1

MONEY SUPPLY TARGETS AND OUTTURNS  
(annual growth in M2)

	Target	Outturn
1984	11	12.3
1985	10	11.1
1986	7-11	9.6
1987	6-9	8.6
1988	6-9	8.9
1989	6-9	9.5
1990	6-9	9.9
1991	5-8	9.0
1992	5-7	6.0
1993	5-7	7.9
1994	5-7	3.1
1995	5	-

Source: Based on Bank of Italy data.

reserves) but also the price (the exchange rate) comes into play in determining the new equilibrium. This reduces or even eliminates the external channel of money creation.

Nevertheless, a look at the Table's figures for 1993 and 1994 and the information available for this year as well does not give the impression that the floating regime has significantly improved money supply performance. The overshoots of 1988-91 and 1993 have given way to undershoots in 1994 and presumably 1995.

The succession of over- and undershoots – not just in Italy but in Germany too – underscores the importance of many “disturbances” in deviating the actual from the desired path of monetary growth. The disturbances include cyclical factors, such as the unexpectedly sharp and protracted recession, structural changes such as the reform of the compulsory reserve regime, innovations that altered the demand and supply functions for financial assets, and changes in the behaviour of intermediaries.

Despite these changes, in Italy as in many other countries the money supply indicator remains a fundamental point of reference for both central bank and market. This may be due to the long-term

stability of the relationship between the money supply and nominal economic growth that macroeconomic studies have demonstrated (Banca d'Italia 1995) or more simply to market operators' endorsement of the Friedmanite assertion that inflation is everywhere and always a monetary phenomenon.

Nor can one deny that in the case of Italy, the M2 aggregate represents a good compromise between the controllability and the visibility of the intermediate variable. The broader it is, the more visible, but at the cost of diminished controllability. Unlike the exchange rate, which as we have said is a quasi-final objective endowed with both great visibility and controllability, a monetary aggregate remains an intermediate target. Accordingly, importance attaches to its relation with the final objective, and this obviously varies over time: a disadvantage, this, of no small account.

### 2.3. Inflation

In the post-devaluation period, then, the removal of the exchange rate anchor was associated with a still problematic money supply target, at least in the short run. Given the insufficient visibility and controllability of the traditional intermediate objectives, the idea arose abroad as in Italy that the central bank can turn its instruments directly to the pursuit of the final objective of controlling the rate of price increases. Aside from the dissatisfaction with the behaviour of the intermediate variable chosen, this trend is also based on the conviction that inflation is an exclusively or at least predominantly monetary phenomenon, and as such open to direct attack.<sup>4</sup>

The adoption of inflation as the immediate target is the most significant monetary policy innovation of recent years, and its pursuit necessitates the development of a series of indicators allowing for prompt use of policy instruments. The approach was first adopted in New Zealand, with a formal pact between Government and central bank governor on a level of inflation that could not be exceeded (Fischer 1995, Walsh 1995). It has since been extended to Canada

<sup>4</sup> Even the advocates of inflation targeting admit that other, non-monetary factors can affect the inflation rate. For this reason many countries (such as Canada) provide “escape clauses” under which deviation of the reference aggregate from the target can be tolerated.

and then Europe, conquering such countries as the United Kingdom, Sweden, Finland and, recently, Spain. In Italy, in his "Concluding Remarks" to this year's annual meeting of the Bank of Italy, Governor Antonio Fazio pronounced himself as follows: "The annual average rate of consumer price inflation, net of the effect of the increase in indirect taxes, could then be held below 4.5 per cent. It will have to fall below 4 per cent next year. If price trends over the next few months show a tendency to diverge from the pattern I have just described, we shall not hesitate to tighten credit conditions still further" (Banca d'Italia 1995). By this token, the inflation rate is not yet an immediate target but is very close to it.

If formulated in the terms that prevail in some other countries, the idea of inflation as the direct target variable might seem quite a rash one. For it would be dangerous to ask the central banker to take this longest leap just when his intermediate points of support are missing or at best unsteady. For one thing, if it is agreed that wage bargaining and the size of the budget deficit are powerful inflationary factors, at least in their impact on expectations, this refutes the premise that rises in the price level are always due solely to excess money supply. Further, in an internationally integrated economy, trends in world raw materials prices and exchange rates are powerful exogenous factors whose neutralization could provoke a sharp and most unwelcome economic recession. This is why some countries (Canada, for one) refer the inflation target to indicators that exclude the effect of raw materials prices.

An examination of Italy's experience over the past fifteen years indicates that disinflation (Table 2) has been successfully pursued only thanks to the convergence of a number of determinants, all within the sphere of economic policy broadly conceived, but not necessarily that of monetary policy. In the last three years the anti-inflationary bent of incomes and fiscal policy has been accentuated and consolidated, easing the burden on monetary policy.

In the policy framework of cooperation and coordination what one can reasonably ask of monetary policymakers is an effort at rationalization, at more visible communication of its contribution to disinflation. However, assigning the central bank to set a target inflation rate, or even a range, would not appear advisable.

Inflation is a tax, a mechanism that redistributes income and wealth. It is up to government, Parliament, and the business and labour organizations involved in the incomes policy machinery to fix

the inflation cap, the rate that should not be exceeded during the relevant period. As an independent authority but one accountable to public opinion, the central bank has the duty of cooperating in achieving the objective and above all pointing out the risks of setting too high a ceiling, as well, naturally, as monitoring continuously actual inflation and reporting regularly to the market, government institutions and the country at large the extent and nature of any overshoots.<sup>5</sup> Such a division of roles makes it possible to curb the inflation hazard implicit in the eclipse of the intermediate anchors of monetary policy without interrupting the central bank's gradual accumulation of credibility.

TABLE 2

INFLATION TARGETS AND OUTTURNS  
(average annual rise in consumer prices)

	Target	Outturn
1984	10.0	10.8
1985	7.0	9.2
1986	6.0	5.9
1987	4.0	4.7
1988	4.5	5.0
1989	4.0	6.3
1990	4.5	6.5
1991	5.0	6.3
1992	4.5	5.2
1993	4.5	4.5
1994	3.5	3.9
1995	4.7	-

Source: Based on Bank of Italy data.

Even under an ideal monetary constitution, therefore, the central bank cannot be responsible for setting an inflation ceiling unless an interval, a relatively narrow range, is set by law, within which the

<sup>5</sup> In a number of countries (e.g., New Zealand), the inflation target is set jointly by the Government and the central bank. In Italy, legally speaking, this task would be that of the Government alone. To my mind, for the sake of separation of roles and responsibilities, the latter is the preferable solution.

choices of the central bank can remain technical ones, not taking on the status of political decisions. A political role for the central bank, i.e. a role as forger of compromise between various values for a given target or, worse, between different objectives, is hard to reconcile with the sort of independence it has claimed and of late attained. In fact, only if the central bank is assigned a single task, namely guaranteeing price stability so defined as to give it strictly technical discretionary powers, is full independence from Government and Parliament institutionally correct, and in this case it is also economically efficient.<sup>6</sup>

If instead the central bank is empowered to use its instruments from time to time to stimulate demand and employment, deemphasizing price stability, and even more if it is responsible for the stability of the banking and financial system, its political powers would be insufficiently counterbalanced by mere accountability before public opinion.

While I do not think that the complex functions now performed by the Bank of Italy and other central banks should necessarily be immolated on the altar of the myth of independence, pared down to the nub of anti-inflation actions, at the same time a monetary constitution whose checks and balances failed to take such multiple objectives and possible compromises into account would risk producing an institution accountable only to itself. Constitutional engineering, especially if it draws on experience and practice, should be capable of designing a model that combines institutional correctness with economic efficiency. But let us not forget that the Maastricht Treaty and the statute of the European Central Bank (ECB) and the European System of Central Banks (ESCB) essentially set a single objective for Stage III, namely price stability (Sarcinelli 1992). Compatibility between this single-function ECB and the multiple tasks of the ESCB member institutions is one of the great issues to be dealt with in the creation of Monetary Union.

<sup>6</sup> For correctness it must be noted that the oft-cited statistical correlation between inflation and measures of formal central bank independence is sometimes disconfirmed by reality and in any case is not robust (Cargill 1995).

### 3. Policy instruments

#### 3.1. *Indications from theoretical analysis*

From a multiplicity of objectives to a multiplicity of instruments: again the revisitation of monetary policy in Italy, even just in recent years, fails to provide an unequivocal solution or a simple recipe.

At the level of economic theory, a clear prescription for the choice of one instrument or another derives only from highly simplified models of the real world. Thus more than two decades ago the American economist William Poole (1970) succeeded in demonstrating that in an economy without foreign trade and without inflation – in an IS-LM framework – controlling the money supply is preferable to controlling interest rates for the purpose of minimizing the fluctuations in nominal output when shocks to the goods market are sharper than those to the money market, and conversely. Taking off from Poole's contribution, theoretical refinements (Henderson 1982) showed that even in the case of an open economy with floating exchange rates, the joint presence of shocks whose financial or real origin is uncertain faces the central bank with the problem of finding the *optimal combination of instruments*.

The same conclusion as to the desirability of diversifying the set of policy levers is reached by considering other sources of uncertainty besides that over the type of shock that may strike the economy. First of all, this refers to the "structural" uncertainty over the nature and position of the functional schedules used to describe the behaviour of agents and markets. Then there is "dynamic" uncertainty, that is, the greater or lesser stability over time of structural parameters, i.e. average propensities observed in static terms. Changes in behaviour may be induced by economic transformation, by institutional reform of markets or more simply by changing strategic interdependencies and new patterns in the formation of expectations; all these elements can multiply the set of dynamic developments that could spring from a single structural model of the economy.

A final consideration, but not without its importance, concerns the uncertainty stemming from the lag with which monetary policy actually affects the performance of the final target variables (Friedman 1968). An excessive lag dilutes the causal relation between activation of the monetary instrument and real economic effect, casting doubt on the advisability of activist monetary policy itself.

This very brief theoretical review helps to focus better on two requirements in choosing a viable set of monetary policy instruments in a world of multiple uncertainties and multiple market agents.

The first criterion is *allocative efficiency* (Angeloni 1994), i.e. the need to minimize the money market distortions generated by monetary instruments in the operation of competitive mechanisms, self-regulatory capacity and spurs to innovation. From this standpoint we can understand why all the leading countries have come to rely on indirect methods of control through signals to the market regarding money supply and interest rates, discarding administrative constraints or at least restricting their use to exceptional and always temporary circumstances. To meet the requirement of allocative efficiency, the indirect instruments themselves must conform to the principles of transparency, equal treatment and equal information, and competitiveness.

Just as necessary to the indirect control option is *informational efficacy*, i.e. the capacity of the set of instruments used to form a viable channel of communication between the monetary authorities and the market. Transparency is needed to meet this second requirement as well, but no less important are visibility and non-ambiguity of interpretation. If central bank watching is not to be an arcane, oracular exercise – adding to uncertainty – then the central bank's actions and its announcements must be intelligible. Only in this way can operators factor the monetary authorities' intentions into their own database. For their part, the authorities need to be able to survey the markets and gauge market moods; trends will be the more predictable, the greater is their efficiency. Every day the global village of finance determines the prices and volumes of the assets transferred, with an eye to a future it does not know but which it seeks to forecast and helps to shape. It wonders about the nature and duration of current movements; it forms expectations. And in this formation, the signals given by monetary policy instruments and announcements have an important, sometimes decisive influence.

Extending Marshall McLuhan's thesis that "the medium is the message" from social to economic communication, we can say that for the financial community the monetary instrument – the policy choice, the action that the central bank undertakes with such instrument – is at once message, medium of communication, and tool of guidance. Hence the importance of sufficient transparency of interventions and operating procedures; they must be clearly legible to the market.

Taking these three summary indications from economic theory – a combination of instruments, allocative efficiency and informational efficacy – let us reflect on the *modus operandi* of Italian monetary policy in the last few years. Though we shall concentrate on the last three years, the argument necessarily starts from the period of fundamental "monetary reforms" since the start of the '80s (Passacantando 1995). These reforms laid the groundwork for Italy to join other countries in instituting indirect tools of monetary control, in keeping with the workings of a mature money market.

### 3.2. *The monetary reforms of the '80s and '90s*

In July 1981 the Bank of Italy ceased acting as residual purchaser of government securities unsubscribed at auction. This obligation, which had made the central bank the Treasury's handmaiden, was sanctioned by resolution of the Interministerial Committee for Credit and Savings in 1975. It is by now something of a commonplace to see this "divorce" as the start of the process of building an efficient money market in Italy. It would be too time-consuming to retrace, step-by-step, the lengthy series of innovations since 1981. Rather, we shall classify them according to the criteria of allocative efficiency and informational efficacy set forth above in discussing monetary policy instruments.

Certainly at the turn of the '80s Italian monetary policy was both subject to and source of constraints, hence distortions of the competitive working of the markets. The central bank sought to attenuate the harmful consequences of the compulsory monetary financing of the Treasury by employing instruments turning crucially on administrative controls on credit, portfolio constraints on the banks and an exceptionally restrictive reserve regime (Sarcinelli 1991).

To overcome this allocative inefficiency, a large number of measures were taken. It was not until 1994, in conformity with the prescriptions of Maastricht, that the umbilical cord of monetary financing of the public sector deficit was definitively severed. The Treasury's overdraft facility with the Bank of Italy was finally abolished outright, and this measure was accompanied by the radical revision and relaxation of reserve rules, designed to lessen the disadvantage of Italian banks with respect to their foreign competitors. Another essential measure to enhance the functionality and allocative



efficiency of interest rate formation was the progressive elimination of floor prices for government paper at auction – first for Treasury bills, in 1988-1989, and then for bonds and credit certificates, in August 1992.

In parallel with these measures involving the new issues market, the principal object of the monetary reforms of the past decade and a half has been the formation of deep, flexible secondary markets which, thanks to the constant contribution of large numbers of participants, can guarantee the conditions for the orderly, efficient financing of sectors in deficit, typically the public sector. The informational efficacy of these markets is undeniable.

The development of screen-based, computerized exchanges for trading in Italian government securities and interbank deposits (MTS, the screen-based market in government securities, went on-line in 1988; MID, the interbank market, in 1990), the launching of futures contracts on Treasury bonds and Euro lira (1991-1992), and the advances in the payment system all strengthened the money market's ability to absorb external shocks, to read the signals and respond effectively to the stimulus of monetary policy, and to formulate indications of its own that are invaluable to economic policymakers in their decisions.

The dimensions of this development are indicated by the volume of turnover on the screen-based circuits. Trading on MTS rose from 72 trillion lire in 1989 (the equivalent of 10 percent of GDP) to nearly 4,000 trillion in 1994 (about 2.5 times GDP). The volume of business transacted on MID tripled in its first four years of existence and was more than three times GDP in 1994. In short, Italy has acquired a more sophisticated and mature money market.

Prepared by the structural reforms of the '80s, there was fertile ground for the more recent measures that have structured the "tool box" now used by the Bank of Italy. First of all came Law 82/1992, which accorded direct power over the official discount rate to the Governor. Even though previously changes in the rate had been made at the Governor's proposal, and there had been no cases of refusal by the Minister of the Treasury to sanction such proposals, there was unquestionably a perception on the part of the markets of increased freedom of monetary policy conduct, hence of the enhanced informational efficacy of central bank watching.

A year earlier, in 1991, a significant reform had revised the penalty mechanism applied to fixed-term advances. Different treat-

ment of different types of institution was eliminated as the first step towards Italy's introduction of a transparent mechanism which, improving allocative efficiency, would show the cost of lending of last resort and furnish the market what could reasonably be presumed to be the upper bound on interbank rates.

Meanwhile, as to quantitative instruments, the capacity of open market operations to assure efficient liquidity control and effectively transmit policy signals was enhanced by the introduction of foreign currency swaps (October 1992) and outright purchases and sales of Treasury bills (February 1994), open only to market makers in the MTS. Italy has not yet introduced repurchase agreements at predetermined rates, a monetary policy instrument in use in Germany, among other countries, and to which we shall return.

To complete the increased depth of the MID, the portion of compulsory reserves that banks are allowed to mobilize has been progressively raised since August to its current level of 10 percent. Increasing the scope for self-regulation by the market and by individual participants in determining the most efficient distribution of liquidity has enhanced the information value – at least potential if not actual – of the monetary policy control machinery.

It is unarguable that over the past decade and a half Italy has conducted a laborious transformation of its monetary regime, understood as the set of rules and institutions that help form expectations concerning the future value of money and that inform the authorities' actions in support of such expectations (Passacantando 1995). Just think of the abandonment of direct controls on lending, on bank balance sheets and on capital movements and the introduction of a set of instruments respectful of allocative efficiency, permitting action that uses the financial resources of the market itself.

In my view, however, Italy has changed not only its monetary regime but also its economic and social regime, which can be defined, to paraphrase the above definition, as the set of rules and institutions that help form expectations concerning the role of the ruling class and that inform the authorities' actions in support of such expectations. In fact, the producer class has been progressively supplanted by consumers, as in all the advanced capitalist societies, and the working class is being replaced by that of holders of financial assets, as in all the advanced financial systems. Whereas in the "old regime",

for instance, the growth of basic industry and the defence of the *scala mobile* cost-of-living allowance mechanism were essential objectives, the new regime makes the growth of competition and the defence of the purchasing power of money top priorities. Without this concomitant, interdependent transformation of the economic regime, the change in monetary regime would have been impossible.

A final observation concerning the monetary regime and the reputation of the monetary authorities is in order. Relations with the financial markets and the public in general cannot be characterized by credibility unless the central bank has managed to accumulate a store of reputation. To build up such a capital, occasional successes, even major ones, are not sufficient, nor even a series of solid results; what is required is consistency between public statements, operational practices and the results of monetary policy and, above all, stability of the monetary regime. When the regime changes, markets and economic agents see at least a temporary diminution in the predictability of the central bank's actions. This is why during the years stretching from 1979 to 1995, when the Bank of Italy has certainly improved its anti-inflation performance, it cannot be said that its reputation in this particular field has improved in proportion. There have been too many alterations in the monetary regime. And insufficient credibility heightens the risks of making the inflation rate a direct target.

### 3.3. European model or "corridor Italian-style"?

In the light of the foregoing, in Italy as elsewhere the central bank, in its monetary control and guidance, relies on a combination of official rate manoeuvres and open market operations.

In the "European model" (Angeloni 1994, De Felice and Esposito 1995), by setting the official discount rate and the rate on advances, the monetary authorities stake out a corridor within which interbank rates are guided through open market operations.

The level of these official rates sums up the current monetary policy stance, indicating what the authorities deem the appropriate level of short-term interest rates. The position of the rate on repurchase agreements in relation to the "ceiling" and "floor" corridor rates reflects the need to absorb temporary, or seemingly temporary, shocks; it signals the likely future course of central bank policy. When the rate on repurchase agreements nears or exceeds the top of the

band, one can expect an increase in the cost of liquidity or else a remodelling of liquidity supplies that eases the pressure generated by the market.

On the German model, the corridor of guideline rates was brought into the set of Italian monetary policy instruments when the lira entered the narrow band of the EMS at the start of 1991. The corridor mechanism was also the result of the new rule allowing mobilization of bank reserves and the related reform of fixed-term advances, which made the rate on the latter a much clearer signal than it had been. In the regime of relatively stable exchange rates prevailing until mid-1992, the European model proved useful in stabilizing market expectations, signalling the capacity of the central bank to modulate interest rate and liquidity movements in defence of the exchange rate. Also, in Italy as in other countries, the institution of the corridor of official rates was a viable technical premise for handier and more transparent monetary policy coordination among ERM members.

The function of the corridor as a benchmark did not vanish with the crisis of 1992 and the lira's withdrawal from the ERM. In a flexible exchange rate regime, the difference between the two official rates signals the measure of the central bank's willingness to tolerate an increase in market rates touched off, presumably, by pressure on the exchange rate. At the same time, the pattern of interbank rate movements within the corridor is the resultant of foreign exchange speculation and countervailing interventions effected by regulating bank liquidity.

Generally speaking, the fundamental advantage of the corridor mechanism lies in the signalling function of the floor and ceiling rates and the power of changes therein to affect market expectations. For this reason (CER 1995), by increasing monetary policy transparency the corridor model retains its usefulness regardless of whether monetary policy is anchored to the exchange rate, the money supply, or the inflation rate.

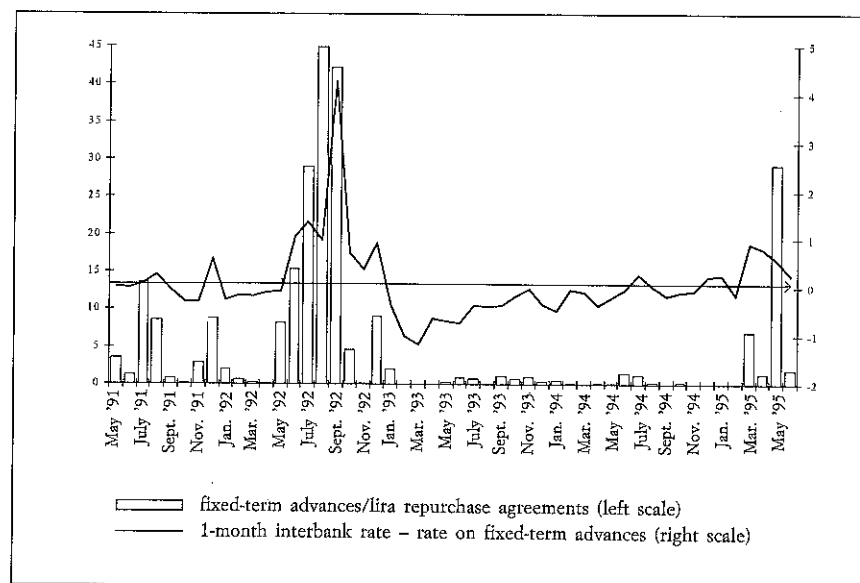
On these premises, we can ask whether and how the corridor schema has worked in Italy since the withdrawal of the lira from the ERM. Of late, respected observers (CER 1995) have complained of a serious deterioration in the signalling capacity of the band in the course of the phase of restrictive monetary policy starting in the summer of 1994. In this view, violating the principle of informational efficacy (that is, transparency and visibility), the interaction between

changes in the official rates and open market operations produced a situation in which the rate on repurchase agreements and interbank yields remained for considerable periods substantially above the "ceiling" represented by the rate on fixed-term advances. By contrast, during the period of declining interest rates in 1993 and early 1994, reductions in the official rates were effectively signalled by previous intra-margin reductions in the rate on repurchases.

A look at the data (Figure 2) reveals that except during the foreign exchange crisis itself (the second half of 1992), in its first four years the corridor of official rates has performed satisfactorily.

FIGURE 2

INCIDENCE OF FIXED-TERM ADVANCED AND OVERSHOOTS  
OF INTERBANK RATES  
(percentages)



Source: Based on Bank of Italy data.

In the 48 months from May 1991 to May 1994, only four times did the interbank rate on one-month funds exceed that on fixed-term advances, and only moderately at that. However, in the twelve months ending in May 1995 RIBOR exceeded the cost of refinancing from the Bank of Italy in seven months; and there was a notable

differential of between 50 and 100 basis points for three consecutive months, March-May 1995.

Attentive analysts (Prometeia 1995) have found that the asymmetric performance of the corridor, and especially its poor functioning in tight monetary conditions, means that there is room for improvement in the allocative efficiency and the transparency of fixed-term advances as an instrument. Despite the reforms of 1991 there remain features, such as the lack of a procedure for allotment of the funds available among all applicants and, say some operators, the Bank of Italy's discretionary concession of this liquidity, that limit the effectiveness of advances, their timeliness and efficacy in countering and defusing market pressures. In Italy's present payment system, discretion in granting advances appears indispensable.

All this is reflected in the statistics, which show the marginal importance of fixed-term advances in recent periods of market tension as well. Looking again at the twelve months ending in May 1995, note that the volume of the advances was always modest, never more than 30 percent of the volume of securities repurchases.

These considerations, and the supporting evidence, strengthen the case for Italy, too, to introduce more streamlined and transparent forms of fixed-rate finance for the money market, along the lines of the repurchase agreements used by the Bundesbank. Even in recognizing the reasons for such a proposal, however, let us not pass over the inevitable tradeoff in terms of decreased short-term control over the monetary base.

Finally, one may ask whether the protracted positioning of interbank rates above the "ceiling" represented by fixed-term advances may be not the undesirable effect of residual inefficiencies in the corridor mechanism but rather the result of a deliberate choice on the part of the monetary authorities.<sup>7</sup> The sacrifice of signalling efficacy resulting from the stickiness of official rates in responding to short-term yield variations could be offset by the benefit of smoothing the transmission of the monetary tightening to the productive economy during an economic recovery – a recovery, moreover, that was utterly uneven in its distribution among industries and regions.

<sup>7</sup> Referring to the early months of 1995, the Bank of Italy's *Annual Report* for 1994 observes that "by rationing the supply of fixed-term advances, [the Bank] induced short-term interbank rates to move above the corridor demarcated by the official rates" (Banca d'Italia 1995, p. 91).

Thanks to this temporary differentiation in the pace of increase between the two official rates, for instance, the rise in banks' lending rates was less steep; bank rates, as we know, are particularly sensitive to the official discount rate. Between May 1994 and May 1995 the interbank rate on one-month funds rose by 2.5 percentage points. Like the discount rate, the rate on fixed-term advances was raised by 2 points. The average rate on lira lending by banks, meanwhile, rose by scarcely 1.5 points. Turning to real interest rates, the cost of bank credit, deflated by the producer price index, dropped by more than 4 percentage points in the year to around 3 percent at the end of the spring (Figure 3). Historically, this is very low. Nevertheless the cost of credit is still the bugbear of industrial users.

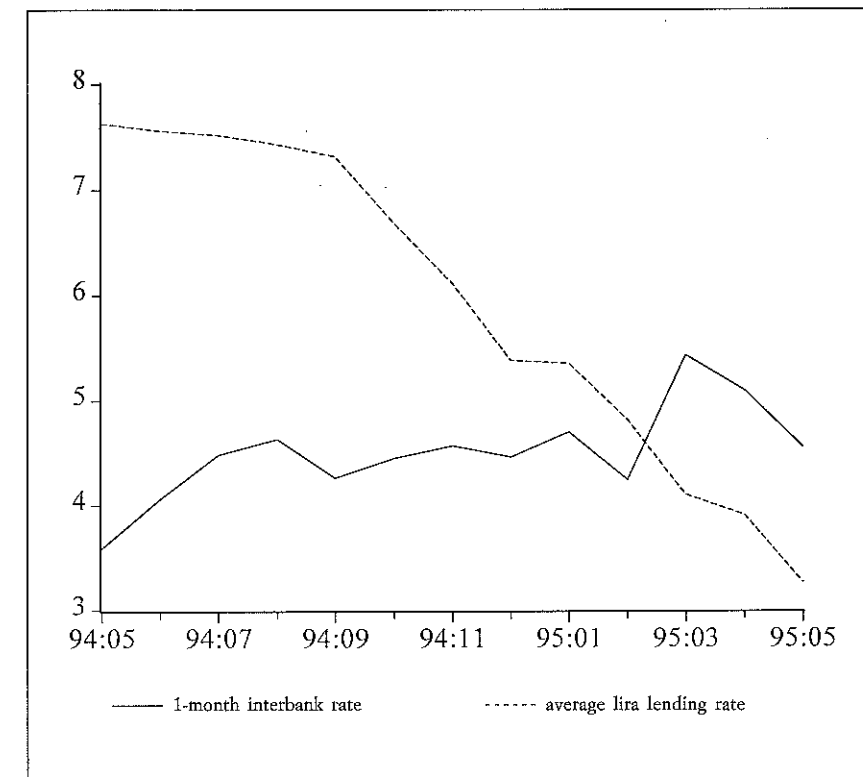
This way of reading the data gives one the impression of a use of the corridor mechanism that has been flexible to say the least. This flexibility, naturally, is temporary; the purpose is to achieve a transitory decoupling of money market yields and bank lending rates at times of especially fierce foreign exchange pressure not justified by the performance of the fundamentals (Cottarelli, Ferri and Generale 1995).

The raising of the official rates itself is not immune to criticism (Spaventa 1995), which has focused on both timing and motivation. The increase of August 1994 was unwelcome to the Government and unclear in its motivation to the markets. That of February 1995 seemed so hasty as to induce the expectation of a close temporal relation, in future, between the release of inflation figures and monetary policy action. Last May's raise was more fortunate. On the first two occasions the reasons cited appeared uncertain both as to target (exchange rate or inflation) and as to type of response (preventive or corrective; Spaventa 1995).

In conclusion, these episodes affecting the "legibility" of recent Italian monetary policy suggest that the "Italian-style" interpretation of the European-model corridor of leading rates undercuts the system's value as policy signal. Nevertheless, in a "high variance" economy such as Italy's remains (Ciocca 1991), Manichaeism is out of the question. Even though the traditional debate between discretionary powers and rules appears to have been settled, at least for now, in favour of the latter, we all know that every rule has its exceptions. Personally, I have never believed in monetary policy as a fixed-schema, repetitive game; room must be allowed both for durable innovation and for case-by-case adaptation. Communication

must be effected in any case, and it must remain consistent and unequivocal. This is why criticism of the Bank of Italy's raising of interest rates is closer to the mark when it focuses on the insufficient or unclear motivation of decisions than on their timing; the fact is that the central bank often has information not available to others that induces it to act.

FIGURE 3

REAL INTEREST RATES: INTERBANK DEPOSITS AND LIRA LENDING  
(monthly averages)

Source: Based on Bank of Italy data.

In short, prudence and flexibility in the use of policy instruments has often been a strength, not a weakness, in the art of central banking. It is likely, and highly desirable, that this will continue to be the case in Stage III of Monetary Union, when it arrives.

#### 4. Towards the completion of the process

Looking back at the path travelled by Italian monetary policy in the '80s and '90s, one cannot but be impressed by the real transformation of the *modus operandi*, the progressive institution of a European model relying on market-based control. And in fact the Bank of Italy devoted much of its energies and its best minds to the creation and development of the money market.

Can the transformation now be considered accomplished? I think not. There are still two areas in which changes are needed, and the sooner the better for a number of reasons, including the accumulation of the central bank's store of reputation. The first area, which is circumscribed in extent and certainly ripe for reform, is the banks' compulsory reserve deposits. The sole regulatory hold-over from the era of direct controls, the reserve deposit, was significantly modified in 1990 to make it at least in part a tool for the depositing bank's own liquidity management. In 1994 the marginal reserve ratio on deposit flows was lowered from 17.5 to 15 percent. No other financially advanced country has kept so high a reserve ratio. Restoring the banks' freedom to lend the funds they raise cannot but increase allocative efficiency and reduce the taxation implicit in the lower yield on the banks' assets held as reserve deposits.

The second area, by contrast, is very extensive and fraught with political and institutional perils, but urgent if Italy intends to honour its agreements and commitments. This is harmonization with European standards if the Bank of Italy is to be a full member of the future European System of Central Banks. The European model, which so far has affected the Bank's *modus operandi*, radically transforming it, cannot fail to affect the structure of the central bank as well, and in particular its non-monetary functions. Will it be possible to have national central banks that are anything but carbon copies of the European Central Bank? The Maastricht Treaty and the Statute of the ECB appear to leave some margin for manoeuvre, as long as the Council of Governors does not decide by qualified majority that these secondary functions interfere with the objectives and the fundamental tasks of the ESCB. But is it not likely that in the revision of national legislation the scales will be tipped in favour of uniformity at all costs

by pressure from the strongest member countries, which are also the advocates of the "pure" central bank; by the desire to reduce and if possible eliminate causes of friction, especially in the delicate start-up phase; and by the desire to simplify and streamline as much as possible a structure that will necessarily be large and complex, given the number of participants? Here, prudence is of the essence, not only in acting but even in forecasting the course of the legislative revision.

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