

Governor Baffi's Monetary Policy *

1. In the recent and valuable *Storia monetaria d'Italia* (Spinelli and Fratianni, 1991), the chapter dedicated to Paolo Baffi's governorship (*ibid.* pp. 688-689) closes with these conclusions:

Paolo Baffi's reports show a governor who distanced himself from monetary policy. In fact, his concluding remarks criticised the practice of stabilisation of interest rates and the recourse to credit ceilings, portfolio constraints and foreign exchange regulations. It often seems as though he were not at the head of the central bank and did not deal at first hand with monetary policy. Our judgment of Baffi as governor is definitely positive.

One cannot but agree with the favourable overall evaluation of his governorship, recognising that the successes of monetary policy in the 1980s owed much to Baffi's theoretical counter-revolution as well as the adjustment he managed to impress on the central bank course of action to further his own convictions. However, what these authors define as a distancing from the practice of monetary management, on the basis of the interpretation of Baffi's "concluding remarks", is neither the invective of the ideologue nor the lament of the theorist: it is simply the manifestation of the conflict between professed convictions nurtured by solid doctrine and experience and the harsh reality of an almost inexistent monetary constitution, a highly expansive fiscal policy, unusually strong and inflation-provoking external shocks, a particularly vulnerable economic structure due to the balance of payments constraint and the rigid relationship between salaries and prices. But this conflict is rationally accommodated by the acceptance of second-best solutions, the imposition of unavoidable

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limits of which the distortive capacity is known, the denial or reduction of margins of freedom through foreign exchange regulations on capital account, despite the discrimination against saving. In other words, Baffi was a man of action as well as a man of learning: he knew how to interpret the economic events of the second half of the 1970s, but in defining and putting into practice the monetary policy which the circumstances dictated, he kept alive the belief of what should have been done, had the conditions been less adverse.

We are less interested in identifying the seeds which bore fruit in the 1980s than in re-examining the main structural factors which Baffi's monetary policy had to deal with, to go over some of the objectives and the results obtained, evaluating the ways and means of his monetary policy-making leadership, reflecting on his attitude towards the EMS. Since the reconquest of national monetary stability was started, but not concluded, we must base our judgment of Baffi's governorship on a number of elements, above all the remarkable improvement in the balance of payments. A few remarks, although only impressionistic, on Baffi the man may help to illuminate the anguish which his actions, as "interventionist" governor, caused his liberal conscience.

I would warn the reader that I am not a disinterested scholar, having been one of Baffi's principal assistants between 1976 and 1979. It is certainly true that the judgment of a participant in an event may not be objective, but it is indubitably vivid, palpitating with reminiscences, aware of the atmosphere in those days, characteristics which time can only weaken, not erase. It may not be history but it is certainly memory.

2. Paolo Baffi was given the task of managing monetary policy in one of the most difficult periods of Italian history, not only recent. He had not yet started when a structural change began to produce its principal negative effects, and he had already finished when new, more favourable circumstances, domestic and foreign, came about. Rightly, Spinelli and Fratianni emphasise that his type of monetary policy produced results in the longer term, but since then contributed to modifying the way of thinking: the judgment of the monetary authorities on the limits to which they were constrained, above all in their relationship with the fiscal authorities, as well as on some of the instruments which the former used continuously and massively in those years.

Baffi definitely saw the problem of tightly linking monetary policy, even in the short term, to the principle of defending the value of the currency – an objective which should in any case guide the central bank in the long term – and thus of regaining full control of high-powered money creation. The removal of that authority from the central bank was due to the sudden and virulent effects that, first in real terms and then on nominal values, the shocks had had in preceding years: this had induced the subordination of money supply to the more general aims of economic policy. It is worth remembering that the "marriage" between the Treasury and the Banca d'Italia was sanctioned by a resolution of the Interministerial Committee on Credit and Savings of March 21, 1975 and much resembled an enforced marriage, consummated on the tide of a series of largely-unexpected events of great impact. The "divorce" could not be but the natural end of an anomalous relationship, which matured in 1982 as a result of the clearheadedness and agreed decisions of Minister Andreatta and Governor Ciampi, but Baffi certainly contributed decisively in propagating the notion that the subordination of monetary policy was unsustainable and, in the long run, dangerous for the nation. In a letter of May 9, 1982, Baffi expressed himself:

I do not remember having been consulted about the marriage: the divorce will prove its worth if and when administrative restrictions are eliminated, and only then. Good results were obtained in the area of credit in 1977-79: the more modest success in international payments was due to opposition to my proposals by the Treasury, the (Ministry of) Foreign Trade and, lastly, Palazzo Chigi (Office of the Prime Minister).

Finally, he prepared the ground for subsequent events, including joining the European Monetary System in 1979, even though by means of a special regime, the wide band, which revealed its usefulness later on for the participation of Spain and the United Kingdom.

These fundamental aspects of monetary management are well illustrated in the book by Spinelli and Fratianni and rightly so, because in every country and all periods of history, the performance of the central banker is judged to a large extent on the simple yardstick of successful defence of the value of the national currency, a defence – it should be noted – that Italian legislation does not mention, leading one to doubt whether the omission is due to the

obviousness of the principle or ... its irrelevance! Baffi often worried about this lack of legal basis, for example in his first "concluding remarks" (Banca d'Italia, 1976), renewing his requests to the legal counsel of the Bank to look into every possible legal text in the hope of finding the desired norm, and envying his colleague at the Bundesbank to whom the law attributed only one objective, at the same time simple and difficult. It should be noted here that monetary constitutions are important, but they do not succeed, nor will they ever, in completely separating the areas of currency and politics. It is worth reflecting on what has taken place recently in Germany between the government and the monetary authorities, despite the latter effectively exercising legally-guaranteed autonomous powers.

Another way of judging the quality of the work of a central banker is to examine how he uses the discretion and flexibility available in the monetary systems of all developed countries. In the 1970s, this second dimension was much extolled because the Italian economy, like others in the OECD, was hit by both violent and unexpected shocks, as shown by the fact that the term "stagflation" was coined only then. Monetary policy was necessarily influenced by this, both in the choice of final objectives – which could not, in the circumstances, be restricted solely to price control, whatever the real repercussions – and, above all, in the choice of instruments and intermediate objectives. It is thus worth distinguishing the structural factors affecting the evolution of the Italian economy in the 1970s which cannot be side-stepped if one wishes fully to understand the effects and modes of monetary policy management of the time.

3. Without claiming to be exhaustive, it is necessary to dwell on three structural factors which concurred to determine the reaction of the Italian economy to the shocks: the indexation of salaries, the crisis of the financial system, particularly of medium-term credit institutions and, finally, the impact of the sudden increase in the terms of trade on the foreign accounts and on the intersectoral allocation of resources.

3.1. The sliding scale for wages and salaries in Italy, as is known, was introduced well before the 1970s, but the degree of indexation, first implicit and, after the agreement on the uniform fixed point, explicit, was very high in that period. This constituted a strong limitation, a real obstacle, not only to monetary action aimed at containing the

inflationary effects of the oil shock, but more generally to an economic policy for combating stagflation in an un-traumatic way and at the same time allowing for a readjustment of relative prices.

Both in historical perspective and with reference to the present, a high level of indexation amplifies the effects of the shocks and lowers the speed of the disinflation. It is not a case of establishing whether the inflationary push of the 1970s was *generated* by the pressure of demand, rather than that of production costs, but of realising that the structural characteristics of the labour market and the mechanism of price formation were such as to enlarge and perpetuate the reply to the exogenous supply shocks which took place in the meantime. Economic literature has confirmed this conclusion. The theory of optimal indexation of Gray (1976) and Fischer (1977) shows us that full rigidity of real salaries – a complete indexing of nominal wages to inflation – becomes sub-optimal as soon as the economy is subject to considerable real shocks. Indeed, complete indexation protects the purchasing power of wages and salaries, but impedes a readjustment of relative prices; since in Italy this was almost total, it is clear that the real shocks contributed to stagflation, giving a strong inertial push to nominal magnitudes. In this context, it is illusory to think that inflation would have fallen without any cost in terms of production and of employment, if only the rate of increase of money supply had been reduced.

Even though he had long worked under Governor Menichella, who feared that the monetary stability of the 1950s could be compromised (through the mechanism of the sliding scale) by accidental scarcity in supply, for example, of agricultural products due to a bad harvest, Baffi was not among those who abhor indexation because it limits the freedom of the economic agents to move the relative prices on the markets of production factors, goods, services or financial products at any time: this explains the phobia which Germany's monetary authorities have for anything which even remotely resembles indexation; for example, the ECU basket. Neither was Baffi a strictly observant monetarist, regarding various forms of indexation as irrelevant mechanisms for the management of monetary policy and its final results: in more than one paper, the first on saving given at the Accademia dei Lincei (1974), another which appeared in *Libro Aperto* (1980), a third – in many respects the most systematic – published in *Politica ed Economia* in 1984, he furthered the cause of indexation. Above all in the latter, he traced the history of the proposals deriving

from the monetary disorder of the 1830s and 1840s, studied its various formulae and the consequences in cases of real or monetary shocks, and through indexation put forward a proposal for a contractual definition of a band in which real salaries could fluctuate.

One can ask how Baffi managed to reconcile his quest for a stable currency with mechanisms which a large number of economists, all central bankers and the general public felt to be, if not sources, certainly propagators of the inflationary movement. The explanation given by Baffi (1984b, p. 55) illustrates his concept:

I realise that the idea – according to which negotiation in real terms could in the end be the means of regaining monetary stability – is contestable. That reconquest is under way, by other means, in most developed countries.

In the course of time, our currency has broken one after another all the moorings which tied its value to base metal: gold convertibility; partial reserve coverage, first of gold and then gold and convertible currencies; fixed exchange rates with the latter. We do not know whether and by which constellation of constitutional norms ... and laws, of agreements defining national currencies in terms of international units and by this and other means limit the fluctuations of exchange rates, of the discipline observed by unions, employers and governments in containing the dynamics of remuneration and the monetary financing of the deficit, lastly of the recourse to monetary restriction, the condition of monetary stability which many countries are again approaching will be safely ensured.

If this result were achieved, the cyclical fluctuations of the value of the currency and, for long-term contracts, its secular trends, would continue to have an effect on the value contents of monetary payments as factors of uncertainty ... Such efforts to search for the conditions, forms and optimal degrees of indexation are thus not trivial.

This also serves to show Baffi's deep conviction that contracts, concerning labour or mortgage, must be observed in real terms or value, as lawyers say: however, his search, for monetary stability that would render the meter invariant with respect to cyclical factors or secular trends, is certainly morally unobjectionable. It is not possible here to discuss whether such absolute vision does not again reduce money to a veil, as in classical economic theory which dealt only with goods: further investigation of this subject must take place in another forum.

Returning to the facts of the 1970s, it does not seem rash to say that, even apart from the degree of indexation, there are a number of good arguments for asserting that the notion of cost-inflation is not at all strange. Recently we heard about research aimed at testing alternative theories of inflation by non-traditional methods. A specific questionnaire, sent to a sample of U.S. companies over the last two years (Blinder, 1991) confirms that in the management of the business, the decisions about the adjustment of product prices are much more influenced by variations in costs than in demand.

Briefly, one can conclude that monetary policy of the 1970s was perhaps an autonomous source of inflationary shocks, at least in certain conditions of high of monetary financing of the public deficit (for example in 1975); however, it would be a great mistake to under-estimate the considerable effect that the high degree of salary coverage had on the process of inflation, in the presence of repeated and substantial external shocks, and the fall in employment and production that a policy of extreme monetary harshness would have otherwise imposed on the country.

3.2. The second structural element which I would briefly mention, and which is perhaps not given enough importance in *Storia monetaria d'Italia*, is the crisis of the credit system and in particular that of the special credit institutions (ICS). I have detailed the reasons for these difficulties in another paper (Sarcinelli, 1981). I would limit myself to the reminder that, with reference to the banks, the slowing of growth worsened the quality of their portfolios to an increasing degree. In relation to total deposits, the quota of non-performing loans went up from 1.2% in 1974 to 4.1% in 1980, while bank capital and reserves rose from 3.1% to only 5.2%, so that the net worth position underwent a substantial deterioration (Table 1).

On the other hand, the special credit institutions were afflicted by much more serious difficulties. These stemmed mainly from the increase and variability of interest rates, which increased the cost of funding more than the return on loans; the heavy concentration of the latter in the sectors worst hit by the recession, as well as that of big borrowers' risks since it had been deemed fit to overlend in order to have large plants completed; finally, the quota of subsidised loans as a total of those given by the special credit institutions, which had risen continuously from the beginning of the 1960s and continued to grow right up until 1979 (Sarcinelli, 1981).

TABLE 1

BALANCE SHEET STRUCTURE OF BANKS: 1974-1980^a
 Values as percentage of customer deposits calculated as average of end-of-quarter data

	1974	1975	1976	1977	1978	1979	1980
ASSETS							
1. Liquidity	2.3	2.8	1.8	1.9	2.2	1.3	1.4
2. Reserve requirement	13.8	12.9	13.7	14.2	14.3	14.5	14.3
3. Domestic loans	64.2	59.7	60.0	56.4	48.0	47.1 ^c	50.2 ^c
3a. in foreign currency	2.7	2.6	3.1	7.6	7.9	7.6	9.8
3b. medium/long-term	13.3	13.2	13.1	13.5	15.4	17.2	18.2
3c. non-performing loans ^b	1.2	1.4	1.4	1.8	2.5	3.1	4.1
4. Treasury bills	1.4	6.2	4.1	9.4	12.2	11.0	10.0
5. Long-term securities of which;	32.0	33.7	32.8	32.3	35.1	35.9	33.2
5a. Government/Treasury	8.8	9.3	8.2	8.2	12.0	14.3	12.2
5b. special credit institutions	17.4	19.5	19.7	19.3	18.6	17.6	17.4
5c. others	5.8	4.9	4.9	4.8	4.5	4.0	3.6
6. Total securities (a+b)	33.4	39.9	36.9	41.7	47.3	46.9	43.2
7. Stocks & shares	1.0	1.1	1.1	1.1	1.1	1.1	1.2
8. Foreign assets	15.5	8.5	8.0	7.3	7.3	8.0	8.8
TOTAL	130.2	124.9	121.5	122.6	120.2	118.2	119.1
LIABILITIES							
9. Customer deposits of which:	100.0	100.0	100.0	100.0	100.0	100.0	100.0
9a. current accounts	55.7	49.9	50.3	50.5	51.8	53.3	54.6
10. Credit from Banca d'Italia	4.2	4.2	2.7	1.8	1.4	2.0	1.2
11. Other domestic funding	1.6	1.2	1.1	0.9	1.1	1.1	0.9
12. Net worth	3.1	4.0	4.3	4.4	4.3	4.6	5.2
13. Balance of interbank accounts	1.7	2.5	1.7	0.8	-0.5	-1.5	-1.8
14. Foreign funding	16.8	9.4	10.1	11.9	11.2	11.5	13.5
15. Sundries	2.8	3.6	1.6	2.8	2.7	1.2	0.1
TOTAL	130.2	124.9	121.5	122.6	120.2	118.9	119.1
16. Interbank debit accounts	17.2	20.8	18.3	18.6	17.7	16.4	17.9
17. Net foreign position (8-14)	-1.3	-0.9	-2.1	-4.6	-3.9	-3.5	-4.7
18. Total loans (3+6)	97.6	99.6	96.9	98.1	95.3	93.9	93.4
19. Quota of medium/long-term loans	41.5	41.7	42.0	40.7	44.6	46.8	45.3
20. Customer deposits (in billions of lire)	74,410	90,784	111,465	136,494	168,043	201,483	229,823

^a Including central credit institutions.

^b In percentage of domestic loans (net of non-performing loans).

^c Including bank acceptances: 396 billion (0.2% of deposits) in 1976 and 611 billion (0.3%) in 1981.

Source: *The Italian Credit and Financial System*. THE TREASURY, 1982.

The vehicle by which monetary policy made its impulses felt, the credit system, fell into serious and perhaps even increasing difficulties over the whole decade. In evaluating the policy of administrative controls on the credit system, one must therefore remember that, to a certain extent, the constraint on the portfolios of the banks which forced them to finance the special credit institutions, although causing distortions, also acted as a preventive measure in alternative to a massive recourse to last-resort credit – anyway technically almost impossible without a change in regulations – in order to avoid a collapse of the long-term credit sector. In this way, controls avoided strong expansion of the monetary base in favour of the banking sector and increased the stability of the credit system, which would otherwise have been ensured by other means. In the meantime, double intermediation maintained the level of investment in the private sector (although by means of an inefficient circuit), avoiding excessive contraction of the flow of funds necessary for capital accumulation (Table 2).

TABLE 2

BANK BORROWERS: 1972-1980
 Values as percentage of total borrowing by ordinary resident customers surveyed by the Banca d'Italia Risk Surveillance Service

	1972	1973	1974	1975	1976	1977	1978	1979	1980
1. Companies	82.7	83.1	84.8	83.1	82.9	87.7	90.7	91.2	90.4
1a. State-owned	17.1	15.7	19.3	18.1	18.5	17.5	15.5	15.4	13.2
1b. main private	28.2	24.8	25.0	23.5	20.9	21.6	20.8	19.9	17.9
1c. other	37.4	42.6	40.5	41.5	43.5	48.6	54.4	55.9	59.3
2. Govt. admin.	14.6	14.4	13.2	14.7	14.7	9.7	6.2	6.1	6.2
2a. central	0.3	0.4	0.5	0.5	0.4	0.5	0.4	0.3	0.5
2b. local	11.4	10.9	11.3	11.3	11.9	6.8	3.4	3.5	3.4
2c. social security	2.9	3.1	2.9	2.9	2.4	2.4	2.4	2.3	2.3
3. Households and non-profit organisations	2.7	2.5	2.3	2.3	2.4	2.6	3.1	2.7	3.4
Public sector (1a+2)	31.7	30.1	32.5	32.8	33.2	27.2	21.7	21.5	19.4
Index of small loans ^a	18.9	16.2	17.4	14.3	12.9	11.9	12.0	16.6	16.1

^a Domestic loans of the "monthly sample" (includes non-performing loans and statutory grain stocks financing) less the Risk Surveillance Services loans in favour of ordinary resident customers, in percentage of the second aggregate.

Source: BANCA D'ITALIA.

In this context, it is worth again referring to Baffi's authority. Although of a liberal spirit and with a strong market orientation, he was forced to suggest or implement a number of controls, both in the foreign exchange market (from the compulsory deposit against imports to the tax on foreign exchange buying, to the more traditional regulation of payments to and from abroad) and the credit system (from the portfolio constraint to the credit ceiling, to the increase of the reserve requirement). He always tried to avoid amassing too many controls, which would unnecessarily decrease the margin of economic freedom and activity, and to ensure that the system of limits kept a minimum of consistency and logical justification. At a conference in Naples, he explained (Baffi, 1977, p. 20):

In the presence of credit ceilings, which themselves limit the competition of loans to bills and bonds in the composition of banking assets, the constraint on portfolios becomes superfluous if one does not give it the task of protecting the securities included in the portfolio from the competition of those excluded ...

Although I understand the reasons which led to the application of such constraints, I would add that if we were to proceed further along the road of administrative controls on credit flows, we would be committing an error of logic, because we would certainly run into conflict between different regulations, that is, the over-determination of the system.

3.3 The last element to consider regards the connection between the changes in the terms of trade, intersectoral reallocation of resources and monetary policy. The shock of raw material prices, substantially worsening the terms of trade, made for a double process of reallocation of resources (from the non-tradeables sector to that of the tradeables) in order to rebalance the structural deficit which had arisen; from the industrial sectors with high-intensity of energy, capital and public subsidies to others, with the aim of adjusting the productive structure to the changes in relative prices and to the lesser availability of credit for the private sector, generated by massive compensatory public intervention deployed over the decade (Sarcinelli, 1981). The process of reallocation involved losses which burdened financial intermediaries; it imposed costs, which were financed mainly by the public purse; it took time, which kept the rate of economic growth low with respect to the past; moreover, it had to be undertaken in a climate of considerably increased international competition.

As a result, the balance of payments on current account could not but be a primary objective of economic policy and particularly monetary policy. The implication of such a constellation of objectives for the latter was to be found not in the definition of the pace of monetary or credit expansion but in the choice of a suitable aggregate as an intermediate variable. On this point, Baffi is clear (1977, p. 23):

The faster the creation of the deficit [on current account], the stronger will be the slowing down of money creation and, with it, internal demand [which] will have in turn a stabilising effect on the balance of payments ... the fixing of the intermediate objective in terms of credit volume requires the implementation, within the economic system, of processes which lead towards external equilibrium.

It is different when the intermediate objective is fixed in terms of expansion of the money supply. In this case, if ... an external deficit appears which, as we know, destroys monetary base, the monetary authorities, in order to keep on the preselected path, will have to compensate such destruction by equivalent financing from the central bank to the treasury or the economy. But operating in this way will block the process of adjustment of the balance of payments, because the economy will not have to suffer a liquidity shortage.

In revisiting the history of monetary policy, one can therefore say that it was the desire to avoid automatic sterilisation which guided the choice of the intermediate objective, given that external equilibrium was among the final ones of monetary policy. That formulation, reconsidered in the light of current economic theory, appears neither obsolete nor unwise. The recent developments of the theory of financial markets have in fact taken on a formulation which was almost abandoned in the 1950s, in order to base it more solidly on informational asymmetries and the structure of credit relationships: this clearly tends towards reducing the role of monetary aggregates and paying more attention to those of credit, as the availability of credit is the springboard which makes investment and production take off (or at least, if the (economy) horse won't drink, that makes it contract when it doesn't get much (credit) water. The preference given to a policy of control of total domestic credit or of other aggregates linked to credit, appears anything but unfounded in today's perspective.

On the technique of controlling the aggregates, which cannot be expected to maintain their preassigned route in difficult conditions,

and in particular if the effective structure of the economy and the credit requirements per unit of production change, Baffi was against excessive interventionism, maintaining that markets and economic agents needed time to react to the stimuli. On the other hand, he was not convinced that the role of the authorities was to decide a route and stick to it at all costs; indeed, he was always willing to adjust the instruments to secure the goal. Almost halfway into his mandate, he observed (1977, p. 25):

... it appears that the press and public opinion do not realise the necessity of continually adjusting the intermediate objectives in the light of the unfolding economic situation, so as to render them consistent with the achievement of the final objectives, the only ones that count.

4. The considerations so far have a common denominator, that is, that Italy in the 1970s had certain exceptional characteristics with respect to previous and subsequent history. In a number of respects the trade-off between the various objectives became more acute, and thus also the choice between joining the fundamental fight against inflation and devising a more flexible policy, aware of the difficulties which continued in the real sector. A great merit of Baffi's governorship was that of having brought the balance of current payments into the black, containing inflation and setting the base for a long-lasting separation of the links between public deficit and monetary growth. However, not even the judgment on Baffi's modes of monetary management could be negative in substance.

In my opinion, *in the particular conditions of those years*, the allocative costs of the policy of administrative controls were probably overtaken by the benefits. Since this is a controversial affirmation, as well as being in contrast with that expressed in *Storia monetaria d'Italia*, it is worth giving it some elaboration. In order to avoid any misunderstanding, I must first state that I am not an advocate or supporter of a system of administrative controls of credit (*cf.* Sarcinelli, 1981, p. 28 " ... financial intermediaries should not be instruments of allocative choices stemming from governments or, even worse, from central banks ..."), but it is my view that the positive repercussions of the recourse to them made in those years should be carefully evaluated. For this reason and no other, I would stress those positive effects, only touching on the cost of controls in terms of allocative distortions, certainly considerable but universally recog-

nised. Incidentally, not only Italy used direct controls on credit in the 1970s; other important countries such as France and Japan, with a long such tradition, used them; the United States and the United Kingdom also resorted to them for a brief period.

4.1. The financial repression of residents, achieved by a number of constraints, both on financial yield and the destination of the flow of funds, had the most visible consequence of keeping the real level of domestic interest below zero – or at least lower than those prevailing abroad – for many years. Given that any policy, including a monetary one aimed exclusively at the fight against inflation, must be valued with respect to the effective benefits that it brings – which is what counts for social welfare – I would detail the effects of a zero or negative real interest rate (Table 3).

TABLE 3

INFLATION AND INTEREST RATES
percentage values

	1975	1976	1977	1978	1979	1980	1981
Rate of change of consumption deflator	17.2	16.8	17.0	12.1	14.8	21.2	19.5
Rate of nominal return on fixed-coupon Government bonds	10.1	12.6	14.7	13.2	13.1	15.3	19.4

Source: BANCA D'ITALIA, Appendix to the *Annual Report*, various years.

The rate of growth in Italy remained well above the European average for the whole decade: however, one might imagine that the negative effects on the growth of non-positive real rates of interest only later manifested themselves, through a sharp decrease in the rate of private saving and thus also of investment. In this respect, referring to Modigliani's theory of the life cycle, we may retain that the relationship between the rate of saving and the real rate of interest is of uncertain sign, because the income-effect and the substitution-effect act in opposite directions, but instead that the rate of saving depends mainly on population and production growth.

Against all empirical evidence, even international, let us suppose, however, that the substitution-effect is prevalent and that the rate of saving therefore varies directly with that of interest: what

do Italian statistics say about saving in the long term? From the five-year averages (Table 4) of the rates of national saving for the years 1960-1988, also distinguished as to public and private, gross and net of depreciation and, finally, adjusted for inflation, we get two pieces of information: (a) the rate of private saving, net and adjusted for inflation, has undergone a slow but constant decrease over a quarter of a century, if we consider that the average value per decade fell from 20% in the 1950s (non-tabulated value) to 17.3% in the 1960s, to 14.5% in the 1970s and to 11.4% for 1980-88; (b) the rate of public saving in the 1970s, adjusted for inflation, remained at about one point less than those of the previous decade, but became negative in 1986-88.

TABLE 4

RATES OF SAVING
Five-year average (three-year for 1986-88) as percentage of income

	Gross			Net			Net and adjusted for inflation		
	(a)	(b)	(c)	(a)	(b)	(c)	(a)	(b)	(c)
1961-65	27.9	25.8	2.1	21.0	18.7	2.3	21.0	17.0	4.0
1966-70	26.6	26.0	0.6	19.6	19.0	0.6	19.6	17.6	2.0
1971-75	25.4	28.7	-3.3	17.1	20.8	-3.7	17.1	15.4	1.7
1976-80	25.8	30.1	-4.3	16.2	21.0	-4.8	16.2	13.7	2.5
1981-85	22.2	28.6	-6.4	11.2	18.5	-7.3	11.2	10.4	0.8
1986-88	21.0	26.7	-5.7	10.3	16.7	-6.4	10.3	12.3	-2.0

^a National saving rate.

^b Saving rate of the private sector.

^c Saving rate of the public sector.

Source: BANCA D'ITALIA.

The evidence for Italy thus shows that, apart from occasional cyclical fluctuations not taken into account by the five-year averages, private saving, net and adjusted for inflation, is far from being clearly related to the real rate of interest: indeed, it appears to be completely independent. It would thus seem to be without foundation to attribute the tendential lowering of private saving to the costs of financial repression.

4.2. If one considers financial repression as a form of taxation, it becomes clear that the use of direct controls as implicit taxes had a considerable effect on, for example, the budget. The value judgments underlining economic analysis and the legal as well as constitutional constraints ("no taxation without representation") make us reject the use of implicit taxes; however, what conclusion can we draw from the point of view of economic policy, particularly in the short-term, under circumstances of high economic disequilibrium? Inflation tax, a direct consequence of insufficiently high nominal interest rates, avoided the fiscal crisis manifesting itself from then on with its present virulence, at the same time offering the opportunity – unfortunately thrown to the wind – of correcting the dynamics of expenditure and revenue well before the task became that of Sisyphus. How to evaluate this effect? If one maintains that, by avoiding his bail-out, the deviant economic agent would be required to change strategy within a reasonable length of time, one can only be critical of a policy of financial repression. The fact remains that the aim of inducing a lower trend towards deficit spending by the political class and parliament, by means of the increased cost of borrowing, revealed itself to be illusory. In the foreword to the Monti Commission's report (Ministero del Tesoro, 1982, p.V), I commented:

The opinion which maintains that rendering the financing of the public deficit more difficult and costly indirectly forces Parliament to reduce the amount ... does not appear analytically founded, even though it is politically justifiable.

The fiscal implication of financial repression can be examined, not only in its impact on the budget but also in its effects on welfare, or rather from the viewpoint of optimal taxation. In this case, it *could* also occur that resorting to inflationary tax in those years was in the last analysis less distortional than other forms of taxes, particularly considering the extraordinary conditions of rigidity of various relative prices. Furthermore, it must be remembered that the non-positive real rates, redistributing wealth from the creditors to the debtors, constituted a very efficient form of subsidies to companies, since it was hardly visible and thus source of little social protest. In years of acute compression of profit margins because of increases in relative prices of other factors, financial repression prevented the balance sheets of the units of production experiencing even more dramatic deterioration.

The redistributive aspect was very clear to Governor Baffi (1977, p. 21), who noted that one of the effects of the effort to shift taxation would have been an unstoppable increase in inflation:

Inflation continues to be the vehicle of massive movements of wealth, even where prolonged knowledge of its prevalent presence has pushed up nominal rates of interest. In defence of the real purchasing power of earned incomes in the presence of inflation, our economy built impregnable defences, so that when purchasing power overtakes the flow of real resources, the adjustment is made only at the cost of holders of financial assets ... Let us now suppose that the savers, by means of new market equilibria or the innovation in the range of financial assets, also end up protecting themselves better ... in this case, since all the major groups are well protected, little by little the areas of absorption of the inflationary loads would be reduced and every excess of liquidity injected into the system ... would provoke an inflationary flood.

4.3. Direct controls on credit, as I have already said, were also implemented to contrast the extensive symptoms of potential instability of the credit system, and in particular of the special credit institutions. Considering the effective danger of many more insolvencies than in fact occurred, one could say that the controls worked. Although I do not wish to dwell on the allocative distortions that controls brought about, one cannot but note that the credit ceiling favoured the less efficient intermediaries, blocking the expansion of the more innovative and organised ones. In terms of the structure of banking system, the growth of medium-sized firms was stimulated, at the expense of the larger ones. This development, as I noted at the time (Sarcinelli, 1981), should not be seen only in a negative light. Indeed, it was the medium-sized credit institutions who tended mainly to grant credit to small- and medium-sized companies, and most helped their clients, establishing new, substitute or additional relationships. One could surmise that these developments were beneficial to that continuous vitality of the small- and medium-sized enterprises, which became so noticeable a few years later.

Finally, I would like to mention foreign exchange controls. Apart from the fact that they were an integral part of administrative regulation of financial flows, one must remember that they performed a more immediate task, with direct effect on the dynamics of the nominal variables: after the maxi-devaluation of 1976, they prevented the exchange rate of the lira from depreciating even further to

become an autonomous source of inflationary shock. Partly due to the effect of the constraints on external relations, partly due to the announcement effect of joining the EMS, the nominal exchange rate of the lira against the dollar remained more or less constant for almost five years. Even if there was a cost to bear in terms of real appreciation, currency regulations prevented inflation going out of control.

The recent complete abolition of all foreign exchange restrictions in compliance with the second EEC directive on the liberalisation of the movement of capital, highlighted the ancillary function that exchange controls performed for tax and monetary policing purposes. Since these requirements have not diminished – indeed the fight against the laundering of dirty money has become paramount with the push of international cooperation – special controls have been instituted which have led some people to lament that liberalisation has been betrayed ... In truth, foreign exchange regulation, even though odious, illiberal and a source of allocative distortions, fulfilled a positive function in tax terms and in the fight against economic crime.

4.4. Notwithstanding the distancing from direct controls (see § 4), I do not wish to give the impression that Baffi's remark in the early 1970s, about my being inclined in that direction, is still valid. The nine years I spent at the Treasury and the three months I passed at the Ministry of Foreign Trade showed my faith in the market and my respect for the economic freedom of the individual, as witnessed by the dismantling of controls and the building of a Government securities market where supply and demand meet freely. As far as real interest rates are concerned, they must be positive in order to fight inflation without limiting freedom or creating distortions; however, in the medium-long term they cannot systematically overtake the growth rate without causing negative effects, for example, on the distribution of income. I wish to emphasise that the judgment on the macro-economic objectives to pursue and the action to be taken *in a given context* must always be characterized by pragmatism, in the full knowledge of the conditions prevailing. Even today, referring to Governor Baffi, I am still convinced of what I said in 1982 (Ministero del Tesoro, p.V) with respect to the conditions of that year:

... one must not fall into fatalistic acceptance of a muddle of current remedies and limitations, neither content oneself with the rationality of

the reality. Direct controls are objectively excessive and, above all, tend to become permanent: even when the crisis that led them to be instituted has disappeared and the trade-off with the market instruments presents itself in more acceptable terms, a type of aversion to the risk deriving from their suppression induces the authorities to keep them in place ... it is right, on one hand, not to ossify the system through furious regulationism, but on the other hand to contain the magnitude of interest rates, at least in the transitional phase.

Unfortunately, it was not clear to the political class that the fight against inflation by means of the monetary lever and the absence of simultaneous action to eliminate the public deficit would have led to an explosion of the interest burden and a rapid accumulation of national debt. The present enormous difficulties of Italian public finance, which sees every improvement made with difficulty in the "primary balance" destroyed and overtaken by interest cost increases, is the price that the present generation and, above all, the future ones will pay for the lost opportunities during the oil counter-shock.

It seems possible to conclude that the management of monetary policy was aimed at removing the decisive factors of inflationary distortion of the Italian economy in the medium-term, while in the short-term it could not help turning to real objectives. In the absence of an adequate number of instruments of intervention, the recourse to administrative credit control was not only necessary, but also in some respects beneficial. It was, however, clear to Baffi that the system of controls was to be regarded as a minor evil, a temporary remedy in a situation of strong disequilibrium, which had to be removed before restoring functionality and freedom. As I have said on other occasions (Sarcinelli, 1989), it seems an irony of destiny that Paolo Baffi, a man of strong free-trade convictions, had to operate in an autarky economy before the war and in one characterised by many constraints afterwards: controls were never as numerous and as widespread in peace time as during his governorship.

5. As *Storia monetaria d'Italia* makes clear, Baffi's main contribution to the positive developments of the 1980s on the fronts of inflation, exchange rates, productivity and central bank autonomy in monetary policy decisions, is constituted by Italy's participation in the EMS and by the negotiation of a transitional regime in order to render higher Italian inflation compatible over time with the exchange rate fluctuations within a band. In his last "concluding

remarks" (Banca d'Italia, 1979, p.375), Baffi was Tacitean on the subject:

Our country's adhesion to the EMS signifies a commitment to reach a degree of monetary stability in line with the average of the Community to which we belong within a short time: well beyond the exchange rate variable, this applies to government finance, productivity, wages, prices.

Governor Ciampi gave the same message in his "concluding remarks" for 1990 (Banca d'Italia, 1991), no longer referring to the EMS but to Economic and Monetary Union; twelve years have passed and Italian politics finds itself confronting the same problems, some of which have in the meantime become less acute, others much more serious.

But Baffi did not easily accept the idea of the EMS, which led to misunderstandings with the European federalist movement that were only resolved much later. He was certainly not against fixed exchange rates for theoretical reasons:

In my opinion, there are no systematic reasons – he told an assembly of foreign exchange dealers in October 1978 – for preferring under any conditions the regime of fixed exchange rates to that of fluctuating ones, or vice-versa; there are only different conditions which require different systems of exchange rates. In the context of Western Europe there are valid reasons for tending towards the regime of fixed exchange rates.

In himself, however, he knew the reasons which led him to be cautious but which he avoided expressing publicly as far as possible, feeling that they belonged to the political domain, to which he did not belong and which was uncongenial to him. Indeed, the key to interpreting his attitude can be found in the closing passage of his speech to the foreign exchange dealers at Ischia, not planned in the written text:

It is a fundamental criterion of political action to tailor commitments to the means available: in this case the means must be measured, not only in terms of reserves and credits, but also of abilities and time span to implement economic policies which do not create inflation.

Any political argument which could be used to ignore the limits and conditions under which we can commit ourselves would therefore be a bad one. The fixed exchange rate regime has not had a high cohesive force in the last sixty years. The EMS will contribute to cohesion, but we

cannot base ourselves on the presumption that it will, as if by magic, develop national energies and consensus that will align internal policy with a system of obligations which were to be defined with excessive harshness.

He was thus sceptical about the ability of the Italian political class to translate the international exchange rate commitment into consistent domestic behavioural change, and he was not wrong. He was, however, wrong in underestimating the strength of the central banks and of European public opinion, by now definitely against inflation. As became clear in his speech at the ten-year celebration of the EMS, his worry was that, in joining the European Monetary System (Baffi, 1989, pp. 35-36), both the Banca d'Italia and the country could lose degrees of freedom in exchange for little or nothing.

In the two and a half years from July 1976 to the end of 1978, the rhythm of Italian inflation had slowed considerably, but the major success of monetary policy was on the foreign front. The balance of payments had been brought into the black after years of deficit, allowing the repayment of foreign loans, the redemption of gold which had been pledged, the reconstitution of currency reserves and Italian creditworthiness ... I felt ill at the idea that such valuable results could be compromised by the participation in a rigorous exchange rate agreement which, linking the lira to the area of the Deutsche mark, would constrain it to a systemic appreciation of the real exchange rate, thus penalising exports.

From this came his insistence on obtaining a wide band of ± 6 or ± 8 percent and on convincing the United Kingdom authorities, another country with a weak currency at the time, to enter the EMS on the same conditions. The second objective failed, but the first was attained and in the various realignments allowed Italy, to give his words (*ibid*, p. 41):

... a gentle transition, without those jumps, that discontinuity in market quotations which stimulate destabilising speculation and often offer it ample profit opportunities.

However, for Baffi words always had their full significance, not that which the ambiguity of the circumstances, and more often of men, could attribute to them, so that the Bremen Declaration promise that the system had to be "at least as rigorous as the snake" was a real nightmare for him. I still remember his strained face on a

grey day in Basle, under the flashes of the photographer, when he signed the agreement between the central banks which technically set up the EMS; when I remarked that he had got what he had promised himself, he replied that the problems were only just starting ... There was no shortage of problems, both for him and me in 1979, but they were of another type: a judicial-financial plot, at the central bank's expense, resulted in Baffi resigning from the governorship that very year, and I followed his example in 1982, after the prosecution dismissed the case.

6. As I have already said, Paolo Baffi was a convinced free-trader in economic relations, both domestic and international. For those who knew him well, it is easy to take for granted his faith in the allocative ability of the market, in the virtues of the invisible hand, in freedom as a basis of economic and political society. However, in his writings there are more allusions than dissertations on the subject, consistent with his style, dry and averse to generalisations. Without claiming to be exhaustive, it is worth noting a few.

In a brief review in the *Giornale degli Economisti* (1936, p. 137), he wrote two paragraphs about *The Oriental Economist*, the first of which runs:

In introducing this Japanese journal, founded in 1895 and since last year also published in English, I would refer to the editors, who warn us that the journal is independent; its views are independent, not influenced by racial, national or other tendencies, apart from a grain of liberalism ...

These words were written just two years before the promulgation of the racial laws in Italy and when the term "liberalism" was systematically replaced by "corporativism" in the contemporary accounts of the national economy.

In an article on Giorgio Mortara, a well-known demographer and his teacher, Paolo Baffi (1967, in *Testimonianze e ricordi*, 1990, p. 30) recalled that, since he had been "nurtured on classical texts on economic liberalism", he was mortified by the campaign against the sanctions imposed by the League of Nations against Italy, in which Mortara participated with great patriotic fervour, also involving the *Giornale degli Economisti*: his teacher, who had to leave Italy a few years later because of his Jewish origins, blamed Baffi, only later conceding with great magnanimity that his pupil's internationalist illusions were only due to his youth!

On the same wavelength and a few years later, Baffi (1985, in *Testimonianze e ricordi*, 1990, p. 112) wrote that at the end of the 1940s he had become diffident about the Keynesian model on the hypothesis of the closed economy:

The coherent way of applying the Keynesian model to a national economy would have been ... to close it; a sinister implication for one like me who, having lived through the experience of autarky, is more inclined to consider the closing of the economy as homogeneous with the negation of economic freedom (apart from anything else) which had caused a reduction in the standard of living of the Italians.

The most ample defence of free trade and freedom was given in an essay on the thoughts and economic philosophy of Angelo Costa, veteran president of the Confederation of Italian Industry. Even if Baffi (1984a, in *Testimonianze e ricordi*, 1990, pp. 193-194) did not directly explain his credo here, from the context it clearly emerges that he agrees with Costa's position, except for Costa's linking economic activity to a cosmogonic vision, to the Book of Genesis. To the extent that it is of interest in this article, Baffi noted:

Freedom is not only a good in itself, indeed the best, but it is instrumental in increasing the standard of living and social progress ... Today the doctrine is investigating relations between freedom, self-interest and sympathy for your neighbour: I mean the sympathy which is already found in Adam Smith's theory of moral sentiments, in Fichte (Sittenlehre) and others. The conclusion of the research, which follows the theorisation and implementation of the economy of welfare, is in line with Costa's thoughts. A few years ago, in an essay on the subject, Thomas Wilson said that sympathy necessarily requires the respect for individuality and the ability to participate in the sense of frustration that a person must feel when his preferences are ignored and their expression limited by the intervention of restrictions and official controls. (*The Market and the State: Essays in Honour of Adam Smith*, Clarendon Press, 1976)

It must be noted that in Baffi's writings there is nothing more revealing than his internal struggle about not being able to respect the freedom and interests of individuals in the implementation of his monetary policy, necessarily interventionist; at most he was able to fall back on sympathy, participating in the sense of frustration of those who were hit by the restrictions: among those, psychologically, Baffi was in the front line. One should not therefore be amazed that

his "concluding remarks" offered so much sympathy as to make Spinelli and Fratianni (1991, pp. 688-689) say:

It often seems as though the writer were not at the head of the central bank and did not conduct monetary policy at first hand.

In truth, Baffi was always at the helm and adapted his sailing to the conditions of the sea and the ship, even though the steering was certainly not in line with his own code of optimal navigation.

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