

I - The reasons for a public debt management policy in Italy

1. Budget policy and debt management policy

An extraordinarily high ratio of public debt to GDP and its too long uninterrupted growth reveal the past and present structural disequilibria of public finances in Italy. The goal of curbing the growth of the ratio of debt to GDP by 1992 has been set by the Treasury Minister and accepted by Parliament.

The dynamics of the debt ratio to GDP is determined by three factors: the "primary" deficit, or the excess of expenditure excluding interest payments over revenue, the real interest cost of debt (the interest burden paid on the stock of debt, net of the loss in real value of the latter caused by inflation); and the real growth of GDP (which is the denominator of the ratio). If only interest-yielding debt on the market is to be considered, the share of borrowing requirements financed by other means (for example, by the Bank of Italy) must be subtracted in order to value the dynamics of the debt ratio.

Table 1 describes the role of each of these factors, and reports their effects in 1987 and 1988. As we can see, the real cost of the debt exceeds the rate of real GDP growth. The real interest rate has exceeded the real growth rate for years in many countries, and this tendency seems likely to continue. Under these conditions, in order to stop the growth of the debt ratio, it will be necessary to achieve a stable primary surplus net of interest payments: the greater the difference between the real interest burden and real growth, and the greater the accumulated stock of debt, the higher the primary surplus net of interest payments that will be required.

Given the fact that Italy's primary deficit is still substantial despite its improvement in 1989, the effort required to stabilize the debt ratio is remarkable, though the experience of other countries demonstrates that it can be accomplished in two or three years. However, the task would become increasingly difficult, technically and politically, if the desired objective were to be continually pushed

TABLE 1

DETERMINANTS OF PUBLIC DEBT GROWTH MARKETABLE SECURITIES AND PO SAVINGS (ratios to GDP)

	1987	1988
1 - Expenditures net of interest payments	44.7	44.6
2 - Financial items	0.1	0.6
3 - Revenues	41.3	42.0
4 - (1)+(2)-(3) = Primary PSBR	3.5	3.2
5 - Interest payments	8.2	8.4
6 - Loss in real value of securities and PO savings	3.8	4.0
7 - (5)-(6)	4.4	4.4
8 - Effects of real GDP growth	1.9	2.7
9 - (7)-(8)	2.5	1.7
10 - Other forms of financing	1.0	0.9
11 - Bank of Italy financing	0.7	0.2
12 - (4)+(9)-(10)-(11)	4.3	3.8
13 - Change in the stock of securities and PO savings	4.5	3.9

Notes: The aggregate considered does not cover the entire public debt, but only bonds and bills on the market and Post Office savings. Instead, interest payments refer to the total debt. As a result, item (7) in the above table slightly overstates the real burden of the debt.

The difference between the effective change in the stock of securities and the sum (12) of its components is due to securities issue discounts.

forward — as it would if the real interest cost of debt were to increase further. Consider that for each additional point of real interest cost of non-monetary debt, the primary surplus to be achieved rises by approximately 0.7 points of GDP.

Some of the main determinants of the real cost of debt are linked to external factors or to the extent of the disequilibrium of public finances: international interest rate levels; the growing share of government securities in households' portfolios; and the premia that the market may require in the case of continued high deficits and an overly sluggish adjustment process. A convincing start toward a reduction of the primary deficit may in itself foster a decline in the real cost of debt, thereby lessening the amount of effort to be undertaken.

The government can, however, resort to other means to reduce the cost of its borrowing, or at least to prevent it from rising. Even though this is the aim of every private issuer's debt management policy, it is all the more important in the case of a government: controlling the real public debt burden can lower not only the

political cost of the resource redistribution required by a strategy for restoring stability to public finances, but also the economic cost of higher distortionary taxation in the future.

In general, reducing the cost of the debt involves not only the flows, or the conditions for financing new net issues, but also the stocks. It is not only a matter of obtaining the most favourable financing conditions, but it is also necessary to lower the risk of adverse shocks, of external or domestic origin, causing a permanent rise in the real cost of the total debt. This second specification is of particular importance when the existing stock of public debt reaches fairly high levels, as in Italy. In this case, the likelihood of adverse shocks, brought about by loss of confidence or portfolio saturation, is increased: the experiences of other countries during the 1920s, when debt crises occurred even though budget equilibrium was achieved, provide enlightening examples. Obviously, the greater the amount of debt, the greater the effects of a rise in its cost.

Before examining in detail, in subsection 4, the specific target of the broad objectives mentioned earlier, it is useful to define the limits which should be placed on a debt management policy: or, more specifically, to clarify what it *cannot* and *must not* contain.

2. Constraints on debt management policy

The first constraint stems from the explicit recognition of the autonomy of monetary policy. Monetary policy is entrusted with the decisions regarding money supply growth, and thus the overall creation of monetary base, as a function of the exchange rate and/or inflation objectives which have been set.

The degree of monetary financing of the deficit *cannot* be considered an additional objective of monetary policy. It follows that a debt policy must accept monetary policy as a given, and not use it merely as a long-term means of reducing the cost of debt.

However, this constraint does not preclude interaction between the two policies, nor does it overlook the need for coordination and cooperation. Typically, monetary control is exercised through open-market operations which affect the yield curve. On the other hand, as will be discussed in section II, the Central Bank can help debt management by guaranteeing appropriate margins of flexibility to

the Treasury in the short term. What should be made clear is that the purpose of controlling the cost of debt cannot be achieved by requesting permanent increases in monetary financing: such a decision does not concern debt management policy, but, rather, macroeconomic policy objectives and, in the long run, the conscious or unconscious choice between explicit budget policy (on the expenditure and/or the revenue side) and hidden taxation, in the form of an increased inflation tax.

Another constraint posed in this paper concerns the choice of management policy instruments. First, recourse to means of an extraordinary nature to affect the size and the nature of the existing stock of debt must be ruled out. The actual cost of such means would outweigh any desired benefits: reducing the growth of the ratio of debt to GDP to zero does not imply that the total borrowing requirements fall to zero, so that the issuer must still continue to resort to the marketplace. An exception to the above statement is the possible (though limited) reduction of debt stock that can be achieved through the sale of government property: provided, of course, that the corresponding revenues are set aside for that purpose, and not considered as a means of financing higher expenditures or lower revenues.

Second, we exclude the recourse to direct or indirect administrative instruments for debt management: for example, securities portfolio constraints or other controls designed to change the assets composition of financial intermediaries and operators. There are three reasons for not using such instruments: in general, they interfere with the efficient allocation of resources; in a market open to international competition, they reduce the ability of national operators to compete and survive; and they hide the actual costs of a continuing structural disequilibrium of public finances.

In conclusion, the second constraint implies that debt management policy instruments must be market oriented: control over the debt burden must be achieved in the marketplace and not in spite of it.

A third constraint involves the acceptance of European monetary integration and of increased freedom for international capital flows, both currently underway. The decline in exchange-rate flexibility, which we are already witnessing, as well as the removal of restrictions to capital flows, have dramatically changed the environment in which debt management is implemented: the important

economic consequences of these developments will be examined briefly in the following subsection.

3. *Monetary and financial integration and debt management policy*

The process of monetary and financial integration can affect debt management policy in a variety of ways.

Firstly, within the above-mentioned framework, exchange-rate targeting occupies an increasingly important role in monetary policy. Two consequences are thus produced. On the one hand, monetary policy must be given the necessary freedom to control liquidity using interest rates. On the other hand, there is a growing need to reduce the effects of short-term changes in interest rates on the total cost of the debt: debt management must therefore encourage a decoupling of the short-term effects of monetary policy and the cost of the debt.

Secondly, the integration process poses some risks, while at the same time offering opportunities for the management of a high public debt. The risks are consequences of both the liberalization and the increased attractiveness of new financial instruments that remove possible liquidity constraints on household spending. Liberalization enables pent-up demand for currency diversification of savings to be met: the demand for domestic-currency-denominated financial assets may therefore decrease. Liberalization also offers greater possibilities for diversification amongst different issuers. In both cases, residents' demand for government securities in lire may decline in relative terms. Financial innovation, in turn, offers increased availability of personal credit to households. As argued in the 1988 Bank of Italy Report, this may lead to a reduced propensity to save — at least as far as financial saving is concerned — with a corresponding reduction in the ability of household portfolios to absorb government securities. Whatever the cause, a decrease in the demand for securities makes it much more difficult to implement a management policy.

On the other hand, market integration even without complete freedom of capital movements to some extent causes the distinction between domestic and foreign saving to lose significance, especially in the case of savings managed by large institutional investors. Within this framework, the place of issue and the currency de-

nomination of a security are of relative importance, if the question of different fiscal treatment is set aside. If conditions exist for adequate liquidity in the market, and the types of securities meet investor needs, capital will flow toward investments, in any currency, offering the highest yields net of expectations of exchange-rate changes. In this sense, the integration process opens access to the savings of non-residents and offers management policy with the opportunities provided by new demand.

It could be assumed, as it is traditionally, that the substitution of residents' savings with non-residents' savings to finance the Treasury (no matter whether this substitution has been initiated by Treasury issues abroad, or whether it happens spontaneously) places an increased burden on the country as a whole. While domestic borrowing leads only to resource redistribution within the country (or debt "from the left hand to the right hand", as it was called two centuries ago), servicing external debt requires a net transfer of resources out of the country.

However, it is necessary to determine whether increased Treasury borrowing from abroad results in higher overall net external indebtedness, measured as the algebraic sum of private indebtedness, public indebtedness and Central Bank official reserves. This certainly does not happen in a situation of fixed exchange rates and high capital mobility. In this case, the overall flow of net external indebtedness is determined by the difference between public-sector borrowing requirements and the balance of private-sector savings and investment, equal to the current account of the balance of payments. A change in Treasury external indebtedness will cause a corresponding change in official reserves if it is sterilized; or an opposite change of private capital flows, if it is not and a change in interest rates is allowed. In both cases, there is a change in the composition, but not in the level of the country's net external indebtedness. The latter, however, could change if, with fixed nominal exchange rates, sustained inflation differentials cause real exchange rates to change, thus affecting the current account.

In a flexible exchange-rate regime, on the other hand, a change in Treasury indebtedness eventually causes a corresponding change in the same direction of overall indebtedness, since the change in the nominal exchange rate affects the current account balance.

In sum, in a situation of fixed or quasi-fixed exchange rates and freedom of capital movements, the distinction between Treasury

indebtedness to residents and non-residents loses significance for two reasons: because changes in indebtedness to non-residents can occur independently of decisions made in this regard by the Treasury; and because changes in Treasury indebtedness to non residents do not affect the net external position of the country.

This leads to two conclusions: one substantial, the other regarding the accounting of financial flows. The first conclusion is that Treasury decisions concerning whether or not to finance its own borrowing abroad — with external issues and favouring the access of non-residents to the domestic market — must be dictated solely by reasons of convenience, and must not be affected by fears about the extent of the country's indebtedness. Of course, convenience places a limit on the amount of borrowing abroad by the public issuer, because of the increasing premia related to the size of the debt required by international markets. The second conclusion is that the traditional distinction between channels of monetary base creation becomes to some extent irrelevant, since the creation of monetary base for the Treasury occurs not only through the traditional channels of the Treasury account with the Central Bank and of the latter's open-market operations, but also when reserves are increased as a result of the purchase of government securities by non residents.

4. Targets and instruments of a debt management policy

4.1 It was mentioned previously that the objective of controlling the cost of debt also requires lower sensitivity of this cost to adverse shocks on interest rates. If the probability of adverse and favourable shocks were equal, the average maturity of the debt would be irrelevant from this point of view: with shocks distributed equally, in the long term the rate of turnover of the debt would not affect its cost. It is thus not surprising that economic analysis is still unclear on the problem of optimal average duration of the debt, with respect to the management of a given stock.

Different conclusions can be drawn from the theoretical and historical research on financial crises. The implicit assumption in this research is that adverse and favourable shocks are not equally distributed, but rather that the former are prevalent. When the debt is large, its turnover is high and obstacles to improving the budgetary

situation are perceived, there are valid reasons for accepting this hypothesis. But if the shocks are asymmetrical, then the shorter the average maturity of the debt, and the higher its turnover rate, the greater their negative effect on the cost of debt. A short average maturity of debt poses the risk of starting a vicious circle: a rise in the cost of debt frustrates the objective of halting its growth, or delays the time when this can be achieved; confidence crises will occur more frequently, thereby pushing interest rates even higher.

In a situation of high public debt, therefore, extending the average maturity of the debt and, at the same time, spreading maturities so as to prevent a concentration of renewals during certain periods, become important considerations in debt management. Moreover, the objective of extending the average maturity serves to fulfill the condition, mentioned earlier, of weakening the link between monetary policy and the debt burden, with the advantage of increased freedom of action for both the Central Bank and the Treasury.

Extending of the average maturity of the debt can, however, turn out to be costly, either because of unforeseen increases in interest rates, or, more generally, in a sustained climate of unfavourable expectations. There is a risk, then, that the premium to be paid to protect the cost of debt from adverse shocks is no less than that very effect that policymakers try to avoid.

4.2 It is up to the management policy to lower the premium to be paid for lengthening the maturity of the debt. To accomplish this, the Treasury must first of all have some flexibility in setting out its issuing policy, so that it has greater freedom in distributing issues over time. In the next section, it will be argued that the present situation of the Treasury current account not only limits the discretionary power of the Central Bank on the control of monetary base creation, but also does not guarantee the Treasury the necessary flexibility in its choice of when to go to the market. Consequently, changes will be proposed both for this situation and for the allocation of decisions between the Central Bank and the Treasury, so as to achieve both greater rigour and greater flexibility.

These proposals have as their origin the need for a clearer separation of responsibilities regarding monetary policy and debt management, and, at the same time, for increased cooperation between the two. Other considerations and proposals concern more

specifically what management policy can do, both to control the cost of debt, and to extend its average maturity.

4.3 First, there is a problem of what type of securities to issue, which will be discussed in the third section. The connection between the type of securities and the cost of debt is based on the following considerations. Individual and institutional investors wish to diversify their purchases of financial assets taking into account the various risks, and the different types of liabilities they can incur. Consequently, a differentiation of demand occurs among various assets types, even when issued by the same institution. Typically, for example, an institutional investor (such as a pension fund) needs long-term securities with a reasonably certain real yield — guaranteed either by a sufficiently high nominal rate, or by explicit real indexation. If issues are based on only one type of security, it is possible that a segment of demand becomes saturated, while others remain unsatisfied, and that as a result the cost to be borne by the issuer is higher than would be the case with greater diversification. This is of particular importance in situations of continuing, active presence of institutional investors in the market.

This, it may rightly be objected, is not the case in Italy, where most government securities are held by households: credit institutions, and, similarly, investment funds, tend more and more to reduce the share of securities in their assets portfolios; the presence of other institutional investors is negligible; and the peculiar nature of our pension legislation also contributes to this situation (see Table 2). In this case, however, what was said above about the consequences of the gradual financial integration in a situation of increasingly stable European exchange rates becomes relevant. Institutional investors, present and active in foreign markets, are potential foreign investors in Italian securities. The attractiveness of Italian government securities will depend on the types of securities which are more appealing to these investors, as will be discussed in more detail in section III.

Another reason for attributing importance to the type of securities stems from the potential contradiction, described at the beginning of this subsection, between the objective of extending the average maturity of the debt, motivated by both the need to protect the cost from adverse shocks and the possibility of separating monetary policy from management policy, and the cost of debt. If

TABLE 2

DISTRIBUTION OF THE PUBLIC DEBT (*)
BY CATEGORY OF HOLDERS

	1987	1988
Households	51.8	57.3
Enterprises	6.3	6.8
Credit institutions	23.4	20.2
Investment funds	4.6	2.9
Insurance companies	2.1	2.2
Foreign	1.2	1.6
	<hr/>	<hr/>
Bank of Italy	89.4	91.0
	10.6	9.0
Total	<hr/>	<hr/>
Memorandum item: share on households' financial wealth	100.0	100.0
	29.1	31.7

(*) BOTs, BTEs, CCTs and other government securities.

Source: Based on Bank of Italy data (Appendix to the 1988 Report, Tables a D 37 and a D 40).

average maturity is extended at a higher cost, this could conflict with the objectives of either controlling inflation or curbing the growth of the ratio of debt to GDP. Traditional forms of financial indexation only partially solve the problem, since they do not weaken the link between monetary policy and the cost of debt. On the other hand, using nominal fixed interest rates as a vehicle for extending the average maturity of the debt can turn out to be too costly in conditions of continued uncertainty regarding inflation or the improvement of public finances. This is why it is necessary to identify types of securities that may overcome these potential contradictions.

4.4 Another area affected by debt management policy concerns, in a broad sense, the interventions necessary to foster efficiency and liquidity in the market, dealt with in section IV of this paper. This section analyzes problems of particular importance affecting the secondary market as well as the primary market and the relationship between them. Resolving these problems may lead to a decline in the cost of debt for the issuer, by improving market signals, reducing the possibility of error and lowering liquidity premia.

There is a problem concerning the extent and the timeliness of information, which the issuer must provide about its policy of issue. There is a problem of market breadth for each security issued, and

therefore of regularity and continuity of issues, so as to prevent useless and costly segmentation. There is a problem of the inner workings of the secondary market, and one of correctly interpreting the signals arising from it. There is a problem of distribution.

The problems mentioned above, which will be dealt with in more detail in the appropriate section, do not involve general issues and do not require strategic decisions. Nobody can deny that it is advantageous to have more efficient and liquid markets, where the significance of prices is higher, and the cost of information is lower. However, we are in an environment in which the most obvious problems seem to be the most difficult to resolve, because of a multitude of institutional, administrative and legislative constraints and also because of a lack of appetite for small-scale reforms. However a coherent framework designed to eliminate all those constraints, that, as we will see, also hamper useful innovation in types of securities, may make it possible to improve substantially on debt management.

4.5 Two other institutional problems should be mentioned.

The first is concerned with the peculiar Italian situation regarding the institutions in charge of the retail distribution of securities. This problem is mentioned because of its importance, but is not dealt with in detail, since it regards matters which are not within the mandate of the Committee. In Italy the demand for government securities stems almost exclusively from households. The sale of securities to households is almost entirely undertaken by banks. The presence of both institutional investors and nonbank intermediaries is negligible. Banks, on the other hand, offer financial assets to the public that are substitutes for government securities, especially when demand is concentrated on short-term instruments: deposits, certificates of deposit, repurchase transactions, other issuers' securities underwritten by banks. Understandably, the needs of the intermediary may conflict with those of the issuer: when this happens, the latter must eventually succumb, since the intermediary is in a position to direct the public's demand for its own convenience. This is a natural fact (which also holds in the case of investment funds); but it can also be the cause of instability, and in the end, of higher cost to the issuer. This would not occur with a more diversified distribution network, which may reduce potential conflicts of interest.

A second problem, which will be examined briefly in the last section of the paper, concerns the way in which the issuer organizes its debt policy. The Italian Treasury is one of the major issuers in the world. As a rule, the principal issuers, such as international organizations, dedicate substantial human and organizational resources to debt management, in order to select the securities to be issued and the conditions for issue, as well as to follow the secondary market. It is far from obvious that the same is true in Italy; however, it is evident that innovations and reforms, although desirable, are not self-generating, since they require a structure which is able to analyze and examine the decisions to be undertaken.

II - Debt management policy and monetary policy: some institutional changes

1. *Autonomy and coordination*

The concept of the separation of the Central Bank and the Treasury, brought to the fore by the "divorce", or the elimination of the Bank of Italy's obligation to purchase any debt that remained unsold in public auctions, has come to manifest itself as greater autonomy of monetary policy, budget policy and debt management. Autonomy, nevertheless, cannot be unconditional. Recent studies examining the hypothesis of the Central Bank and Government each determining its own strategy confirm that it is not possible for the monetary and fiscal authorities to independently define and pursue their own objectives, since this may cause instability or, in any event, suboptimal results.

The separation is therefore based on the assignment of distinct spheres of action — with monetary policy attributed to the Central Bank and debt policy to the Treasury — rather than on independent objectives and instruments. It follows that the division of responsibilities between monetary policy and debt policy does not in any way preclude forms of cooperation and coordination between the two. In his recent "Concluding Remarks", the Governor stressed the importance of this, offering a flexible interpretation of the relationship between the Treasury and the Bank of Italy.

On the one hand, it is necessary that the instruments and strategies of debt policy and monetary policy be distinct and managed separately by the Treasury and the Bank of Italy in order to clarify the signals arising from monetary policy and to ensure orderly market conditions. On the other hand, it is necessary to encourage, in a pragmatic way, greater cooperation between the monetary authorities and to strengthen the institutions allowing for greater coordination of monetary policy and budget policy. One important aspect of this interaction that requires strengthening is the timely and systematic exchange of the most complete information available on all issues which may be of importance in the decision-making of each institution.

Within the current system, the Treasury's power to vary the discount rate, as well as the rules governing the use of the Treasury overdraft with the Bank of Italy can be fitted into a framework of policy coordination, and are important aspects of this. But certainly cooperation and coordination could be better achieved if changes (or a reinterpretation) of current procedures were to occur in areas of government responsible for defining economic policy objectives.

The underlying criterion for possible change is as follows: the Bank of Italy should assume full responsibility for all decisions regarding the conventional instruments of monetary policy; and the Treasury should be given greater autonomy in managing the public debt, without conflicting with the objectives of Central Bank monetary policy.

The high level of inefficiency of Italy's markets, until reforms can be completed — as in the case of the secondary wholesale market for government securities — or until they translate into concrete changes — such as the projected reform of the regime of bank reserve requirements and the resultant rise in interbank market efficiency — causes the Central Bank's signals to be delayed and prevents them from being perceived accurately by operators.

In order to more clearly signal the stance of monetary policy, it may be useful to alter more frequently either official discount rates or the penalty rates for overuse of the overdraft facility with the Bank of Italy. Nonetheless, it is true that the constraints placed on monetary policy by the size and the growth of public debt, and by the imperfect functioning of the money market, are the principal obstacles in Italy to changes in the official discount rates that are as timely and flexible as those in other countries. Perhaps it is also true

that the seriousness attached to the procedure — in Italy it is the Treasury Minister who decides, on the suggestion of the Governor of the Bank of Italy, to change the official discount rate — may have dramatized it excessively.

To avoid this type of friction, it may be useful to place the responsibility of changing official discount rates with the Bank of Italy. At the same time, so as to respect the political responsibility of the Treasury Minister for the Central Bank's operations (according to the current philosophy of our political system), adequate procedures should be established to inform the Treasury Minister of the reasons and objectives of the intervention.

2. *Monetary policy and automatic financing of the Treasury*

The shift in monetary policy from direct to indirect means of controlling credit, after the divorce, after the reform of bank reserves in December 1982, and after the removal of the ceiling on bank loan volumes and of constraints on the composition of bank's portfolios, has brought about a change in its transmission mechanisms. Central Bank signals increasingly emphasize the role of interest rates, while intermediate objectives of a quantitative nature, regarding the growth of M2 and bank credit, are gradually decreasing in importance.

However, it is true that the Central Bank must be able to control the monetary base in order to correctly define the stance of monetary policy or at least to control major monetary variables. Though the divorce restored to the Bank of Italy the primary responsibility for controlling liquidity within the system, it is also true that Central Bank autonomy in defining a policy of supply of monetary base is limited by legislation allowing the Treasury automatic recourse to credit from the Central Bank.

Nonetheless, the degree of freedom offered by the rules governing the extent of the Treasury overdraft facility with the Bank of Italy and its use throughout the year do not necessarily jeopardize an effective monetary policy: while the rule of money supply growth at a constant rate is not guaranteed by the absence of an automatic channel of financing, as demonstrated by the United States' experience, it is not a condition to be systematically pursued, given the instability of the demand for money.

The Bank of Italy, on the other hand, is able to offset and even to reverse an expansion of monetary base initiated by the Treasury through the use of the overdraft on its current account, when this is judged to conflict with the objectives of monetary policy, by employing its own instruments in order to reduce liquidity (*i.e.* securities repurchase agreement operations (sale), open-market sales of securities, etc.). Further, the Central Bank can always decide whether to purchase securities at issue, according to the extent of automatic financing it intends to make available to the Treasury, or according to the quantity of monetary base it considers necessary to create using this channel. Even in situations of temporary excess supply of securities with respect to available liquidity, the Central Bank can allow a given quantity of securities to be placed on the market, thus limiting the use of the current account, through securities repurchase agreement operations (purchase) by which the necessary liquidity is made available.

What really matters is the overall amount of monetary base created through all channels, and not only through the Treasury, or more specifically, through the Treasury current account (although there are limits to the possible extent of compensation between the various sources of money creation). In fact, rarely has there been a problem of excess creation of monetary base because of the addition of automatic Treasury financing to creation of monetary base through other channels, for example the external sector. In only a couple of cases (in 1979 and again in 1988), the monetary base created through the Treasury overdraft facility exceeded the total monetary base created by the Treasury: thus the possibility that this type of financing may be dangerous becomes more hypothetical than concrete. Further, as mentioned in the previous section, in the case of substantial purchases of Treasury securities by foreign investors (or of substantial sales of Treasury securities directly in foreign markets), the distinction between the two channels of creation of monetary base tends to become meaningless.

Foreign financing offers additional freedom to the Treasury. In a framework of increased capital flows, this may explain why the Delors Report intends to eliminate the direct access of the Treasury to Central Bank credit and to other forms of monetary financing, while still allowing open-market operations on government securities.

Even the Delors Report, however, does not appear to rule out

the possibility of temporary accommodation on the part of the Central Bank, to provide the Treasury with some degree of short-term flexibility. This is a practice adopted by almost every country: virtually everywhere, provisions for short-term, temporary Central Bank financing of the Treasury exist, though more limited than in Italy in their size and duration, as obviously cash requirements are smaller in countries with smaller deficits and debt.

3. Flexibility in the use of current account borrowing and debt management

It is difficult to distinguish between a strict notion of flexibility in the use of current account borrowing, to cope with the lack of synchronization between expenditures and revenues, and temporary financing of the Treasury.

The behaviour of the Treasury current account is not affected solely by that of inflows and outflows, but also by that of borrowing and of repayment of loans. In the case of a balanced state budget, the Treasury current account behaviour depends on the extent to which short-term securities are employed to compensate temporary disequilibria. In a deficit situation, the current account is part of a complex liquidity system, which can be described, in simplified terms, as a system in which the Treasury spends "first" (drawing on the current account) and "later", through securities issues, recovers the monetary base injected into the system. The daily current account balance, then, depends not only on the rules governing inflows and outflows, but also on how smoothly debt is issued.

In terms of the amount of monetary base injected into the system, there is apparently no difference between a framework with a predetermined "available margin" on the overdraft facility to be transformed into monetary base through Treasury expenditure, and one in which there is no margin but the Central Bank is more involved in open-market purchase operations, or more willing to lend more to banks. The second framework, however, would mean increased monetary control by the Central Bank, but at the same time it would severely limit the Treasury autonomy in debt management.

In a system with no "available margin", where the Central Bank

would assume full responsibility for decisions regarding the supply of monetary base and the timing of its injection into the system, the Treasury would have no alternative but to always offer securities equalling its borrowing requirements, plus the quantity necessary for the renewal of stock at maturity. In this system, the Treasury's role in public debt management would be limited to selecting the type of debt for issue: the latter would, however, be strongly influenced by Central Bank decisions regarding the creation of monetary base. Treasury autonomy regarding the timeliness of anticipating or delaying issues, and, consequently, concerning the extent of recourse to the market would vanish; this would lead to important repercussions on debt management and on the cost of financing.

An effective debt management policy, instead, also requires that it be possible to decide when securities should be issued.

More frequent use of the overdraft may be appropriate, for instance when the quantities of securities supplied to cover borrowing requirements and redemptions are particularly large and negative expectations in the market regarding the outcome of the auction, may cause unwarranted interest rate fluctuations. Similarly, when speculation compels the Central Bank to raise interest rates in order to protect the exchange rate, it may be worthwhile to have recourse to the financing facility with the Central Bank and delay issues of Treasury securities, in order to prevent the burden of exchange rate protection from affecting the Treasury borrowing requirements through a rise in the interest cost. The condition here is that the Central Bank be able to offset the Treasury-created monetary base by adequately increasing interest rates on its liquidity-curbing operations.

The advantages of moving the burden from the Treasury to the Bank are twofold: on the one hand, it would prevent the decline in the average maturity of debt which results from issuing in crisis situations; on the other hand, it would avoid the increase in short-term interest rates affecting index-linked securities yields, and therefore the servicing of the public debt.

In the light of the above considerations, it seems clear that the division of monetary policy and of budget policy and debt management into distinct spheres of action not only does not require the elimination of Central Bank short-term financing facilities available to the Treasury, but actually encourages their existence.

The current legislation on the Treasury current account is

seriously defective. Monetary financing within a given period is made to depend on what occurred in past periods. In addition, the link between the ceiling to the overdraft with its size of expenditure appropriations in the budget leads to a confusion of stock and flow values, while the reference variable — appropriations, rather than cost spending and only for the State budget — has little logical connection with the need to create monetary base. Finally, this legislation penalizes the Treasury precisely when it succeeds in controlling the growth of its spending: a reduction in the margin of flexibility may thus jeopardize the outcome of a plan of fiscal recovery.

Consequently, while the total quantity of monetary base to be created through this channel should be more clearly defined, and could be limited with respect to the current situation, the flexibility of current account borrowing should be increased so as to allow more autonomy to public debt management.

It is necessary to find a middle road between the Treasury's need for autonomy in managing the public debt, and the need to guarantee the control of liquidity by the Central Bank and preserve the autonomy of monetary policy.

The proposed solution is to emphasize the use of the current account as an instrument of short-term borrowing flexibility, while limiting and eventually ruling out its use as a permanent means of financing borrowing requirements. Since the function of monetary financing of the Treasury cannot be clearly separated from the liquidity requirements arising from a lack of synchronization between inflows and outflows (including loan repayments and new issues), the creation of a temporary "stand-by" financing provision with the Bank of Italy would provide a cash reserve to the Treasury that could even replace the present system of automatic financing to the overdraft limit on the current account.

This limit may be lowered by consensus as far as permanent use of monetary base created through the Treasury current account is concerned, but it may be raised for the purposes of temporary financing. As an alternative, if the existing legislation appears to be too rigid compared to the new system, a parallel stand-by facility could be created and allowed to mix with the current account. This type of innovation would be more appropriate, more effective and better understood, if it were accompanied by a credible process of adjustment of the public finances.

The line of credit should have a three-month maturity: this term for paying back the monetary base created through the available margin seems sufficient to guarantee greater autonomy in debt management. The three-month period should not however be artificially extended: in order to avoid this uninterrupted recourse to credit in subsequent quarters should be prevented by adequate provisions.

The meaning of this proposal becomes clearer if we consider that currently a virtually unlimited line of credit exists, since the current account balance is only audited at the end of the month; a pre-set line of credit should instead eliminate the possibility of excess borrowing, even in the short term.

There does not seem to be any danger of "permissive" use of the line of credit, not only because the "pure" auction methods (without base rates) should bring short-term Treasury interest rates into line with Central Bank rates, but also because greater Treasury responsibility for debt management should lead to an appropriate use of the line of credit.

If incentives are considered necessary to achieve this, the possibility of readjusting the cost of the line of credit, with penalty rates after a certain level of use, may be examined (even though the principle that Central Bank profits are transferred to the Treasury tends to weaken the argument in favour of financial penalty rates).

The three-month available margin could be determined annually by the Treasury and the Bank of Italy, using parameters such as the Treasury borrowing requirement, its variability and the portion of debt to be redeemed. On this condition, it may be appropriate to introduce a few administrative innovations (or to suggest a few reforms) so as to reduce the variability and the unpredictable nature of monthly borrowing requirements.

The size of the margin available for short-term flexibility should also depend on the way in which the current account will be used as a means of permanent financing. In principle, the Treasury, even in the absence of legislative changes, must attempt to use its annual available margin only according to the conditions set out in the general agreement on monetary financing of the Treasury and on the coordination of monetary policy and budget policy. In anticipation of greater European integration, the system to be established should conform to those in existence in other EC countries.

In order to arrive at a sharper definition of the role of the

current account, and in the case of a change in legislation, the possibility of converting the outstanding current account debt stock into securities held in the Central Bank portfolio may be considered: these securities could possibly be unredeemable but negotiable with open-market operations.

4. *Compulsory reserves and administrative controls*

Together with the discount rate, changes in the required reserve ratio is one of the conventional instruments of monetary policy. In a scenario in which the Bank of Italy assumed full responsibility for the use of monetary policy instruments, also decisions as to compulsory reserves, which are at present under the purview of the Interministerial Committee for Credit and Savings, should fall within its sphere (liabilities subject to reserve requirements, *i.e.* whether they include banks' net foreign currency positions, compulsory reserve ratio, return on reserves).

As argued in section I (subsection 2), we rule out the use of direct or indirect administrative instruments for debt management. If this view is accepted — as has largely been the case in recent years — the legislative authority to introduce these constraints through administrative channels becomes unnecessary, but not without cost.

This authority poses, in particular, problems of credibility. Especially in certain phases, the market foresees the possibility of the constraints being reintroduced, and protects itself from this risk: for example, by requesting a premium to cover the risk of portfolio constraints being placed on securities; or in the case of banks, increasingly substituting government securities with bank lending activity when a reintroduction of a ceiling on bank loan volumes is expected.

If the authorities intend to permanently forego the use of these instruments (which become less necessary in order to conduct monetary policy, as indirect means of control become more effective), they may as well make their intention more credible by depriving themselves of the option of using administrative constraints. It is therefore advisable to revise the legislation allowing the discretionary use of controls of this kind.¹

¹ Professor Maria Teresa Salvemini does not agree with this conclusion regarding the possibility of eliminating the optional use of administrative constraints.

5. Conclusions

In short, the above analysis leads to the following conclusions:

1. the full responsibility for monetary policy should be attributed to the Bank of Italy and that for public debt policy to the Treasury;

2. the separation of responsibilities does not imply absolute autonomy and requires a flexible interpretation of the Treasury-Bank of Italy relationship;

3. it is desirable that the Bank of Italy be given full authority to alter the official discount rate as well as responsibility for all decisions on compulsory reserves;

4. there is a need to strengthen institutions for the coordination of monetary policy and budget policy;

5. there is a need for an adequate available margin for financing of the Treasury by the Bank of Italy, in the form of a liquidity reserve.

For given macroeconomic conditions, this margin must be set according to borrowing requirements and the amount of debt at maturity to be renewed; however, to avoid the temptation toward improper use, the decision should be part of the coordination of economic and budget policies, taking into account the overall monetary financing of the Treasury;

6. it is proposed that the Treasury be given full discretion over the use of the stand-by facility, conditional upon a reorganization of the ways in which flows are forecast and debt policy is decided;

7. it is proposed that the disposable margin, possibly in the form of a three-month stand-by facility, be determined every year by the Bank of Italy and the Treasury, taking into account the main variables of public finances;

8. the present system of automatic credit (14% of the state budget expenditure appropriations), made available at the beginning of each year in the Treasury current account, permanently creates monetary base and reveals a series of shortcomings which can only be remedied by means of an agreement between the Treasury and the Central Bank;

9. it is desirable to forego the use of constraints and, by extension, to remove the option of imposing them through administrative channels.

III - Types of securities

This section will reiterate some previous proposals.² We add some observations on the innovations already introduced, as well as further proposals regarding possible improvements to Treasury option certificates (CTOs), or the ways to attract non-residents' savings toward our public debt securities.

1. The CCTs (*Certificati di Credito del Tesoro*)

As discussed in the first section, the underlying criterion of the proposals is to pursue the lengthening of the average maturity, after the worrisome decline that occurred between the summer of 1987 and early 1989, by finding a way to lower the premium required at present for longer maturities.

Lengthening must concern not only the average maturity of the debt, so as to reduce the turnover rate, but also the yield curve, so as to free the cost of public debt from the conduct of monetary policy. It follows that the average maturity of debt should not be achieved by resorting to financial indexation, as was done in the past, but, rather, by strengthening the fixed nominal or real yield sector.

This does not mean that the Treasury credit certificates (CCTs) will never again be able to occupy an important place among the public debt financing instruments once the current crisis, brought about by fiscal segmentation and by the attempt to move CCTs to a hybrid state of limited liquidity, has been overcome. In order to allow recourse to CCTs, though with a decrease of their share on both stocks and flows, it was proposed that these securities have shorter maturity; that they be highly liquid; that the segmentation of issues be reduced; that the causes of mistrust resulting from the method used to determine reference rates be removed; that the quotations in the secondary market be supported.

Some of those proposals were implemented with some benefit for the quotations, especially in recent periods. New issues, all with five-year maturities, have however not been well received and have been discontinued. The open issues, proposed for CCTs as for other

² MINISTERO DEL TESORO, *Rapporto sull'attività nel 1988 del Comitato Scientifico Consultivo sul Debito Pubblico*, Roma, febbraio 1989.

types of securities, encounter fiscal constraints, which will be explained in the next section; restrictions that could easily be lifted but are still in place.

2. Fixed-rate securities: the CTOs (*Certificati del Tesoro con Opzione*)

One of the first proposals made by the Committee dealt with the issue of medium-term nominal fixed-rate securities with an option to redeem at par after a shorter period than maturity (retractable bonds). The reasoning behind such a proposal was based on the need to reduce the conflict between the extension of average maturity and real interest cost.

Extending the average maturity of debt by issuing fixed-rate securities is in fact a delicate operation. The auctioning of a new instrument that probes market expectations for maturities almost unexplored up to now may cause very steep yield curves, reflecting the cost of "building a market", or uncertain expectations regarding future inflation.

Since it is impossible to discern between an "entrance fee to the market" and the uncertainty of expectations as to future inflation, the issuer accepting a very steep yield curve runs the risk of "validating" inflationary expectations that are inconsistent with its own objectives. If nominal yields are promised that are too high in relation to inflation objectives, this indicates the willingness to bear an equally high real debt burden. This willingness may eventually lose credibility because of the difficulty in imposing additional sacrifices in order to achieve a primary surplus that is sufficient to halt the growth of the debt/GDP ratio.

Real or foreign-exchange indexation helps to eliminate this dilemma, but does not help to build a market for fixed-rate securities in lire. The only way is to proceed towards longer average maturities step by step, so as to prevent an upswing of the yield curve. Along this gradual path, CTOs can serve a useful purpose, as a means of reducing public mistrust toward a relatively long-term security, while at the same time keeping down its cost to the Treasury.

After a first and unsuccessful experiment, the most recent CTO issues have served this purpose.

Consider, for example, the CTO issue maturing on 1/6/95.

Even though on paper it is a six-year security, it is impossible to determine a six-year fixed rate of interest on the basis of its characteristics and its price. Still, it is possible to use the CTO to "test" market expectations beyond the three-year limit.

The market considers CTOs to be three-year securities at a fixed rate of interest, with the option of continuing beyond three years if the price rises above par; one month after issue, the option is quoting at 15-50 basis points (bid-offer spread) on the secondary market. Thanks to CTOs, it is possible to detect a demand from operators ready to pay 15 basis points for the right to buy *in three years* a three-year fixed-rate security with a net yield of around 11.8 per cent. Therefore, some operators are willing to gamble on a decline in three-year rates below this level in three years' time.

This is a primary role of CTOs: we could call it "paving the way for maturity extension". To assess the future role of this instrument, we must ask ourselves what purpose CTOs would serve if a structure of yields by maturity already existed, that is, if we had already made the necessary investment to create a market for long-term securities. The function of CTOs in such a market would be to provide the issuer with a *guarantee* against changes in expectations. Consider, for example, the effect of a surge in inflationary expectations that the issuer does not consider justified and does not intend to accommodate through an increase in yields at issue. One solution would be to shorten the maturity of the new issues, so that the securities mature just before the time when an inflationary increase is expected. CTOs can otherwise be resorted to as an alternative. If expectations are proven to be unjustified, the option will not be exercised: the shortening the average maturity of the debt will thus have been avoided, without having to pay an unnecessary risk premium.

The role of CTOs in a broad market for long-term securities suggests that the maturity of these securities should be similar to that of the normal fixed-income securities which should be issued in the near future: for example, six years. The choice of the time when the option can be exercised (in this case 3 + 3 or 4 + 2) should depend on the conditions of the secondary market for BTPs. In fact, CTO yields at issue should be at par with the secondary BTP market yields up to the period in which the option can be exercised: this implies that the option base price at auction should be equal to zero while leaving it up to the auction to determine the equilibrium price. Viewed from this angle, it seems important that the reference BTPs

be a sufficiently liquid security. It is also advisable to retain the six-year maturity for a little while longer so as to avoid market segmentation, that is, to make the recently issued CTO market more liquid before moving on to different maturities.

It has been correctly observed that CTOs can be considered either a six-year security (in the case of the most recent issues), with a put option to sell at par, or as a three-year security with a call option to buy at par a comparable security maturing after another three years. From an economic viewpoint, there is no difference between the issue of a retractable six-year security after three years and that of a three-year security extendible for another three years. Nonetheless, there could be a working difference as far as the separate negotiability of the option is concerned: this becomes more feasible when in the form of a purchase warrant. A three-year CTO (referring, as always, to the most recent issues), with a "detachable" repurchase option may better fulfill operators' requirements and as such may be placed on the market at more favourable conditions.

The possibility of issuing this type of security is denied on the basis of Law 468/1978, art. 2, subs. 9, amended by Law 362/1988, which states "the law approving the State budget determines each year the maximum amount of issues of public debt securities, in Italy and abroad, net of those to be redeemed...". Based on a literal interpretation, it has been argued that this rule prevents the Treasury from deciding on issues "in future years", as would be the case if securities with the option of purchasing similar securities after a certain date were sold now. First it looks as if a broader interpretation is legitimate and could be validated, by the appropriate authorities, as was done to overcome the formal obstacles to the creation of the screen-based market. As an alternative, a small legislative change would help to solve a problem of which legislators were certainly unaware. Once again, it is a question of making minor reforms.

3. *Fixed-income securities: the BTPs (Buoni del Tesoro Poliennali)*

In the future, nominal fixed-rate Treasury bonds must become the main component of the public debt. A sufficiently broad market of fixed-rate securities that are uniform in their characteristics and

evenly distributed over different maturities is necessary to build a significant yield curve reflecting the state of expectations and of which the short-term segment would receive and re-transmit the impulses of monetary policy.

In Italy, we still have far to go before achieving at this situation, which is normal in other countries. This diversity is to a large extent due to the damage caused firstly by high inflation and secondly by the rapid growth of the debt and by the sustained disequilibrium of public finance that causes recurrent expectations of interest rate increases resulting from the trends of borrowing requirements and renewals. However, to some extent the divergence depends also on past choices of debt management: the privilege given to financial indexation even when the curbing of inflation was at a sufficiently advanced stage; the subsequent discontinuity of medium-term issues that is reflected in corresponding discontinuities in the yield curve and in a bunching of maturities in particular periods. This discontinuity of maturities is detrimental to orderly debt management since it increases both the probability of adverse shocks on expectations and the consequences of these shocks on the average cost of debt.

In order to avoid such disadvantages, BTPs should be issued regularly, though with flexibility as to the size of each issue and with greater recourse to CTOs in particular instances. Furthermore, open-series issues, based on the model of the French OATs, may be able to fill any empty or too thin segments in the yield curve.

There remains the problem of achieving a gradual lengthening of BTPs maturity, for which CTOs are a partial solution. A relevant constraint to this process is due, as mentioned earlier, to the absence in Italy of institutional investors prone by nature to acquire long-term financial assets matching liabilities of comparable duration. We also noted that the internationalization of markets and the reduced flexibility of exchange rates may help to overcome this obstacle.

A "credible" exchange rate and high nominal interest rates may combine to create a potential demand from certain foreign institutional investors, for fixed-rate securities in lire. The problem is to select the securities that will be more appealing to these operators. The benchmark for institutions (for example, pension funds) is a 10-year fixed-rate security: securities with these characteristics should therefore be issued. It must be noted, however, that the success of an issue, especially when it is directed toward foreign investors, depends also on an appropriate information, preparation

and advertising activity: the example is the experience of the French Treasury which has succeeded in making its securities very appealing to international investors. Moreover, success depends on the creation of conditions which in other countries seem completely normal but that in Italy are entirely missing: such as, for example, the quick physical availability of the issued securities and their immediate quotation on the official market.

The success of issues, even in small amounts, of 10-year fixed-income securities subscribed by foreign investors could help the extension of average maturity also because of the positive influence that it could exercise on the propensities of domestic investors.

4. *Real-indexation securities*

Since the release of its first document, the Committee had already recommended the issuing of long-term real-indexation securities, or BTRs (Real Treasury Bonds). The issuing of BTRs is consistent with the intent to increase the popularity of BTPs as well. In fact, there may be complementarity in the demand for the two types of securities: BTPs will be requested by those whose inflationary expectations are characterized by a low expected value and/or low variance; BTRs will be requested by those who expect higher inflation and/or whose expectations are more uncertain; both types of securities are suitable to portfolio strategies aiming at minimizing overall risk.

The characteristics of BTRs can be defined as follows:

(i) capital-value indexation rather than indexation on the coupon interest, for two reasons: a clearer guarantee of protection from inflation for the subscriber as well as payment of the indexed amount only upon redemption. As far as the level of the real rate of interest is concerned, the Committee believes that the scope exists to grant an attractive rate that is nonetheless lower than the real rates implicit in the most recent issues of BTPs.

(ii) The price index to which BTRs are linked should be easily understood by private investors and not lend itself to manipulations: the ISTAT consumer price index would serve the purpose. The legislative change recommended by the Committee in order to remove the limit posed by article 38, paragraph (c) of Law 119/1981,

amended by Article 19 of Law 887/1984 (which authorizes the issuing of "lira-denominated securities whose interest and capital can be revalued according to the trends of a price index net of changes in indirect taxation") has been undertaken within the framework of the Budget Law package, which delegates the responsibility for the choice of the indexation parameter to the Treasury Minister.

(iii) Ten-year maturity, with the possibility of even longer maturities (as may be requested by institutional investors) with higher rates.

(iv) Underwriting Consortia for the first issues, to be paired with foreign issues. BTRs should then be issued with sufficient regularity, overcoming possible initial difficulties so as to allow a gradual familiarization with the new securities and an adequate market breadth. Given the innovative nature of the security, the need to provide information on its nature and technical characteristics to the public becomes even greater.

It is also necessary to encourage, from the beginning, an efficient secondary market for the new securities: for this purpose, it would be convenient to place them in the screen-based system, with the members of the underwriting consortium participating in the market.

At the beginning of the year, the Treasury Minister announced the possible issuing of BTRs as one of the management directives for 1989. It is to be borne in mind that a significant amount of time is needed to take the first steps in the desired direction.

5. *Foreign borrowing and recourse to foreign savings*

As explained in the first section, the liberalization of capital movements tends to blur the distinctions based on the residence of the subscriber and on the markets where issues are placed that were relevant in the past. Foreign-resident capital can be used to purchase domestic-issued securities, as was the case in Italy during the second half of 1988; residents can purchase foreign debt instruments. Further, there is no necessary link between the currency denomination of the loan and the issuing country: foreign currency loans can be issued domestically; lira-denominated lending can be issued abroad. We have also argued that, in a situation of fixed exchange rates, a change in the Treasury's foreign borrowing does not cause a

corresponding variation in the country's external debt position. It follows that Treasury decisions should be made for reasons of convenience.

Against this background, the best criterion is that of finding instruments which appeal to the widest possible cross-section of investors, irrespective of their residence, pinpointing the securities preferred by the different market segments.

Of course, considerations of a fiscal and practical nature suggest that the choice of market in which to issue is of great importance. Issues on the Euromarket are not subjected to the problems related to delays in the physical availability of the securities issued on the domestic market — and the physical availability is often a determinant factor in the case of institutional investors. In the case of countries with which Italy has entered into double-taxation treaties, the delay involved in the repayment of domestic withholding taxes is a source of concern to foreign investors. This problem does not arise in the case of issues placed on foreign markets, since these securities are tax exempt. The fact that domestic securities can be sold through the auction process is an advantage with respect to foreign issues. An effective debt management policy must therefore choose, for reasons of convenience, the investors to be targeted, the currency of issue, and the market in which to issue.

The possibility of creating securities in lire issued on the domestic market which may also appeal to foreign investors has already been considered. One of the reasons for the difficulties the Treasury encounters in extending the average maturity of the debt is the lack of domestic investors similar to the Anglo-Saxon pension funds: the combination of a fixed exchange rate and relatively high yields in lire could remove a structural barrier and bring about the creation of a market for Government securities with domestic issues aimed at foreign institutional investors.

Greater recourse to Treasury foreign-currency-denominated issues to be sold on the domestic market for medium- to long-term securities should be looked upon favourably. At this time, in particular, it can be argued that there would be savings for the Treasury and an announcement effect consistent with a policy of stable exchange rates and lower inflation. First, the issue of *Ecu-denominated* securities should be more frequent and regular and should involve larger amounts. But securities payable and redeemable in foreign currency could also be issued domestically. In the case

of the ECU, this would allow equal conditions for domestic and foreign securities. The innovation could perhaps be extended to a security payable in a specific EEC currency: reference to the market rate of that currency would make comparisons easier and allow the security to circulate freely in Europe.

As far as recourse to international markets is concerned, in Italy, the share of overall public debt issued abroad is by far lower than that of other countries with high levels of debt, or even of countries who have successfully restored stability to their public finances. Also for this reason, the Republic can definitely be considered a prime borrower on international markets, with a potential for borrowing which has been used only to a very small extent up to now. We are not proposing an abstract rule of systematic recourse to foreign debt for large amounts each year. It is only suggested that when the opportunity presents itself, the Treasury should take advantage.

Increasing recourse to foreign issues poses two problems.

These securities are not sold through the auction process but are placed with underwriting consortia headed by an international bank. In order to prevent rent positions and to increase competition among the underwriters, it may be appropriate to form a pool of institutions, from which the lead-manager is chosen each time on a case-by-case basis, and not in a predetermined way.

In addition, large and discontinued issues such as those made directly abroad can cause problems for the secondary market for securities of the Italian Republic. Better functioning of the secondary market for Italian securities requires a certain degree of standardization (using, whenever possible, an open series for successive *tranches* of the same issue); it especially requires that market trends be constantly monitored by the issuer.

An interesting possibility to be considered is the issue of securities on national markets abroad (especially in the United States), and not only on the Euromarket, in order to benefit from certain advantages, especially in terms of maturities, offered by the former.

One point in favor of the creation of a sufficiently broad market for foreign currency-denominated securities is that in a situation of fixed, but not irrevocably fixed exchange rates, the Central Bank may be subjected to speculative attacks. Resisting attack means letting interest rates rise as high as exchange rate expectations lead them. During a speculative attack, the Treasury is faced with a

difficult choice: if it has faith in the Central Bank's ability to resist, it will not want to issue securities in lire, in order not to pay a risk premium to speculators; recourse to monetary financing may on the other hand pose problems. The dilemmas of the Treasury — and market uneasiness concerning the way these dilemmas will be resolved — can create a situation in which expectations are self-generating and a currency crisis becomes more likely. In this situation, the availability of a broad market for foreign currency-denominated securities provides the Treasury with an escape route which in itself strengthens exchange-rate credibility.

IV - The working of the markets

This section will analyze certain issues and put forward some proposals to improve the working of securities markets. As mentioned in the first section, market liquidity and efficiency are important to a management policy aimed at controlling the cost of debt. Markets that perform well allow the issuer to match the most suitable instruments to the various segments of demand, to avoid paying liquidity premia to savers, and to set issuing conditions and the amount of issues on the basis of reliable signals.

The problems to be considered affect not only the primary market, its terms and conditions of issue and the characteristics of its securities, but also the secondary market. Strictly speaking, the distinction between the two markets is not really necessary: a more efficient secondary market is useful to the primary market, but it also depends on the way in which issues are managed. The distinction will nonetheless be maintained throughout this section, beginning with the problems of the secondary market.

To some extent, the problems examined in this section typically fall into the category of small reforms: they do not cost much, they do not present major political choices, they provide definite advantages, and they contribute to the removal of obstacles resulting from age-old regulations and legislators' carelessness. On the other hand, it is also necessary to guarantee that the individual reforms be viewed in a consistent framework: thus the desirability of long-term securities acting as benchmarks and being issued regularly to give breadth to the market as well as the growth of a futures market all work together to increase the efficiency of the secondary market.

1. The secondary market: the experience of the reform

At the beginning of the Committee's mandate, the government securities market was obviously experiencing some difficulty, especially regarding CCTs, for a variety of reasons examined previously. The segmentation of the market and the composition of the banks' securities portfolios had intensified the effect of the interest-rate increases in 1987; lock-in effects, especially for the banks, were the result. Moreover, the belief that reference rates, and particularly the interest rate on 12-month BOTs, were being kept artificially low caused investor confidence to be shaken.

The creation of the screen-based market for government securities, which became operational on May 16, 1988, has been an important first step toward the improvement of secondary market conditions; other steps in the same direction should follow.

The reform of the secondary market for government securities, undertaken in the autumn of 1987 on the initiative of the Treasury Minister, is in many ways similar to the reforms implemented in other major financial markets during the same period. In October 1986, the government securities market was reorganized in the United Kingdom; on January 1, 1987, the *Spécialistes en Valeur du Trésor* began to operate in France; on July 23, 1987, the new *Government Securities Act* came into force in the United States. All of these reforms have a single objective: to insure efficiency, accountability and liquidity in the secondary market for government securities. What the United States legislation calls a "fair, honest and liquid" market, or what the French Ministry of the Economy describes as a market characterized by "liberté, égalité, modernité". The instruments used are also similar: screen-based systems, to distribute information on prices and for negotiations; and intermediaries that operate on their own, using competitive means to make the market more liquid ("primary dealers" in the United States, "market makers" in the United Kingdom, SVT in France).

The reform undertaken in Italy is similar in its organization to that of other countries. The differences are a result of the peculiarities of the Italian market. In our case, the reform is to take place gradually, broadening with time the range of securities being negotiated on the new screen-based market; further, unlike the Anglo-Saxon experience, the primary dealers are almost exclusively banks.

Judging from the first year of activity of the new market for

government securities in operation since May 16, 1988, the gradual pace of our reform allows changes and corrections to be made as the need for them arises.

Although the reform began as an experiment — with the possibility of temporary withdrawals from the obligations of the Convention, and before the system was fully functional — it can be said that the working of the market has conformed to the rules which had been set, especially with regard to the conditions of accountability and competitiveness stipulated in the Ministerial Decree.

Since October 24, 1988, the list of securities has grown from 20 to 30: 20 CCTs, 8 BTPs (including the September and October 1988 issues) and 2 CTEs are currently negotiated.

During the first months, the following positive aspects have become evident:

1) a gradual rise in activity levels, as dealers learn and the system (which will only be completed in 1989) becomes technically more efficient;

2) a reduction of the bid-offer spread as the market becomes more competitive;

3) a rise in the number of dealers effectively involved and thus a decrease in market concentration;

4) no change in the volume of stock exchange transactions, which remained unaffected by the new screen-based system. During the period May 16, 1988 - May 15, 1989, the transactions on the screen-based market for the 20-30 listed securities amounted to 65.5 trillion lire, compared with 16.1 trillion lire negotiated on the stock exchange during the same period for all government securities quoted.

2. *The secondary market: problems and proposals*

There is little doubt that the creation of this market has allowed the quick and efficient management of portfolio adjustments made necessary by the segmentation of securities and interest-rate movements. Although our view of this first phase is generally favourable, there remain, however, some problems for which a solution must still be found.

The main problems appear to be the following:

a) levels of activity have turned out to be very uneven, as

transactions concentrated on a small range of securities (at first CCTs at 6.25%, followed by BTPs after October 1988).

b) Some of the primary dealers have maintained uncompetitive bid-offer spreads, and have therefore not taken an active role in the market.

c) The volatility of the margins has remained high, also reflecting the uncertainty about interest rate trends linked to issuing conditions on the primary market. In periods of greater uncertainty, characterized by particularly high peaks of the bid-offer spread and by corresponding troughs in transactions volumes, interventions by the Bank of Italy have stabilized the market, in particular during March of this year.

These problems — and others of lesser importance — will be overcome in part by the gradual growth of the market. To some degree they were caused by market segmentation of the negotiated securities (due especially to different fiscal treatment and different indexation formulas of CCTs). In part, however, they require additional interventions by the authorities, to promote further growth of the market and an improvement of its efficiency and liquidity. The following measures would help in this direction.

(i) It would be desirable for all the primary dealers' transactions in securities listed on the screen-based system to be recorded, whereas recording is now required only for transactions of no less than 5 billion lire. This threshold should therefore be lowered. A threshold of 2-3 billion lire would be compatible with the wholesale nature of the market.

(ii) All primary dealers — bank and nonbank — must be guaranteed the same operating conditions. New functions could be attributed to them in order to broaden their activity.

The reforms of the money market, of the compulsory reserve and of the payment system will contribute to improve market performance (for bank and nonbank operators). Further reductions in stamp duties, whose cost for shorter-term operations (repurchase agreements) is still too high, may be warranted to conform with development in other European markets.

(iii) It is essential that BOTs also be quoted on this market, as is the case on foreign markets. Currently, in Italy, BOTs do not have an official quotation, and the stagnation of their market has diminished their role as an instrument of liquidity management. The removal of floor prices for BOT auctions is consistent with the

continuous quotation of these securities on the screen-based system; this, on the other hand, will improve the efficiency of the primary market, by determining reference rates for each auction. An organized market for short-term securities could also be used by Bank of Italy to carry out its open-market operations.

(iv) A prompt listing of newly-issued securities would promote the growth of the market. Transactions on such securities should start as early as possible, as the rationale for a wholesale secondary market is dealing with securities which have not already been placed entirely in households' portfolios. Indeed, the experience of other countries shows that the primary dealers have developed a market for securities "when issued", by quoting bid and offer prices of recently announced issues, with settlement on auction day. Since 1987 this type of quotation has been regulated in both United Kingdom and France for long-term issues: the explicit purpose was to elicit market signals as to the expected auction price.

(v) Finally, the authorities and the dealers should work together towards the creation of a futures market for government securities, as requested many times by the dealers. Even without investigating the operational details of this proposal, it can be noted that the new screen-based system provides the technical conditions (continual negotiation) required by the futures contracts and that its performance depends on the extent to which the primary dealers can effectively "cover" the risk of their exposure. In addition, legislation regarding the accountability of the options market seems necessary. These instruments help transactions on the securities market to flow more smoothly and provide important information on dealers' expectations: the Italian market, despite its substantial growth during the last few years, is not transparent enough and probably the risks are high and competitiveness is low. Article 21 of draft bill 953, approved by the Senate on April 27, 1989, delegates to the Italian government the authority to issue, before December 31, 1992, legislation governing the institution of a futures market (futures and options). As it takes time to organize these markets, the government, after the final approval of the draft bill, should lose no time in issuing the appropriate legislation.

These interventions mostly regard the workings of the screen-based market. One of the objectives of reform was also to make the placement of government securities more efficient. The formation of meaningful prices on the secondary market, made possible by greater

competition and transparency resulting from the reform, should therefore help set the conditions for new issues. If this does not happen, the secondary market itself will suffer the consequences, either because its role is neglected, or because of the uncertainty as to whether prices at issue will reflect market prices. It is therefore essential to tighten the link between secondary market pricing and the pricing of new issues.

3. Relationships between primary and secondary markets: the terms of issue

The planning of issues and the ways to make the issued securities as homogeneous as possible, avoiding the segmentation that occurs when many securities of the same type exist, and the techniques of issue both for BOTs and for medium- and long-term securities, are problems which affect our issuing policy.

The main characteristics of the procedures currently in place are as follows:

1) a strategy of issue which extends beyond one month is not announced in advance, nor does it seem to be defined on a regular basis.

2) The dates of issue are quite regular, especially as far as the turnover of the debt about to expire is concerned, but there is no commitment to issue securities of the same kind as those at maturity.

3) The information made available to the operators is unequal: the dates on which BOTs are issued are fixed and the amount to be issued is easily predictable; BTP, CCT and BTE issues are the most uncertain: CTEs are issued through a consortium and therefore the operators involved are informed in advance. It was recently announced that from now on BTPs and CCTs will be issued at the beginning of the month and CTOs and CTEs at mid-month. However, it has not been specified whether all four types of securities will be issued every month.

4) The marketing of each issue (excluding BOTs and BTEs) only consists of advertisements in the main daily newspapers; no indications are given regarding the available alternatives among different government securities, upcoming issues, or the characteristics and advantages of new securities introduced on the market.

Up to now, apparently, the rationale has been that it is *not*

convenient for the Treasury to plan and announce its issues in advance: for fear that the unpredictability of the monthly borrowing requirement would lead to market disturbances, or that more information would result in collusion among the operators at the expense of the issuer; or in the belief that the Treasury should maintain the greatest freedom to issue what is at each time more appealing to the market, in order to minimize interest costs. This approach gained acceptance during a period when BOT issues prevailed, while registered medium- and long-term securities were issued only in "favourable" circumstances. It is not by chance that in countries where long-term securities prevail, the opposite view is adopted.

The analysis of experiences in other countries shows that no uniform model exists. There is a variety of issuing techniques and there are varying degrees of information to the market. However, some trends can be detected:

1) in the countries with larger and more efficient securities markets (such as the United States and Great Britain) auction issues prevail, and information is offered in advance about the issuing schedule and the types of securities to be issued.

2) France, the country which places the greatest emphasis on the "liquidity" of the government securities market and thus on homogeneity, negotiability and predictability (the amount of OATs and BTNs to be issued are announced in advance annually and quarterly), has also conformed to this model in the last few years in order to promote the internationalization of the market.

3) Small countries with high public debt, such as Belgium and Ireland, resort only marginally to issues through the auction mechanism and traditionally have not attached much importance either to market growth or to information to operators.

In view of the growing financial liberalization and integration, debt management in Italy ought to move closer to the Anglo-Saxon and now French experience, which emphasizes the negotiability of the debt and thus the efficiency of the related market. If this is true, it then follows that:

1) auctions should become the prevailing mode of issue;

2) the dates of issue and the types of securities to be issued should be made known to the public.

In principle, yearly planning of issues of medium- and long-term securities is advisable to promote efficiency in the secondary

market and stability of the demand in the primary market; BOT (and BTE) issues would vary with the actual behaviour of the monthly borrowing requirement, and would therefore, in a sense, be determined "residually". This would also serve to reverse the "information privilege" currently enjoyed by BOTs, which have up to now been the most homogeneous securities and those whose dates of issue are the most predictable.

The yearly plan would announce in advance only the type of securities to be issued and the dates of issue. Quarterly announcements would then specify the amounts. This is the practice in the United States and in France.

As for the terms of issue, there are several ways to make the issues as homogeneous as possible and to reduce their number: the purpose is to avoid the segmentation caused by a multitude of issues of limited amounts (with low liquidity on the market), and to promote instead issues of homogeneous securities for substantial amounts which can serve as benchmarks and give the market sufficient breadth. The success of BTP issues 1-9-1992 and 1-10-1992 is a convincing example of the advantages provided by this strategy.

Two possibilities have been considered in particular:

a) open-series issues;

b) securities of the same maturity issued in subsequent *tranches* within a specified period.

The second alternative seems preferable, also in order to improve the performance of the secondary market.

To bring the yields of the successive *tranches* in line with the actual market yield, either the price at issue or the price of the first coupon can be changed. The latter method can be used with CCTs, which could be issued consistently at the same price, while the adjustment to prevailing market conditions would be assured by varying the first coupon (until the payment of the coupon itself, the different *tranches* would then be perfectly equal). In the case of BTPs issued through auction such an adjustment can be made by varying the floor price at issue: this, however, requires that a fiscal problem be solved. Since currently the spread between the price at issue and the value at redemption is also taxed at the source and since this spread may vary from one *tranche* to another, the tax to be paid at maturity would be different for each and different *tranches* would never be considered homogeneous by the market.

The withholding tax on the difference between the price at

issue and the redemption value is applied at the maturity of the securities: as market prices over their life-span tend to neglect the cost of this type of levy an exact assessment of actual yields, which do not depend only on market prices, becomes particularly complex.

Greater transparency in the pricing process may be fostered by applying the withholding tax when securities are issued, thus considering the spread between the redemption and the issue price not as a right to credit to be exercised by the owner of these securities, but as a portion of income that is paid at the time of underwriting; in such a way, unlike what happens at present, yields would be fully comparable on the basis of market prices. Essentially, it is proposed to adopt a criterion similar to that currently applied to zero-coupon securities with maturity up to 12 months, for which the interest is presumed to be paid in advance. This also requires a change in the current tax and accounting practice, according to which the withholding tax on the issue discount must be paid by the last owner of the security at the time of redemption. With the proposed new system, the difference between the price at issue and the redemption value (comparable to a sort of subscription premium) would be attributed to the first owner, who should also pay the corresponding withholding tax, properly discounted back to obtain its present value.

Whether by this or other means, it is in any case urgent that the problem be solved quickly, since the advantages provided by the cumulative issue of successive *tranches* of a single security seem to be indispensable to improve the performance of the markets.

The Committee also examined the possible links between the auction method for six- and twelve-month BOTs and the situation which had developed in the CCT market. Recognizing that the maintenance of an auction base rate for short-term securities, whose yield serves to determine that of CCTs, generated mistrust in the market toward medium-term, floating-rate securities, some alternative solutions were considered.

Two possibilities were examined to remove the risk that, without an auction base rate, anomalous peaks of yields for bids at the margin would occur, with destabilizing short-term consequences and undesirable effects on the cost of the debt: bids by the Bank of Italy at the auction, as already happens for the three-month BOTs; or the proviso that the Treasury reserves the right not to accept some

bids, in which case a floor price, not made known in advance to the market, should be set before or after the auction.

The solution adopted in March of this year, applicable to all BOTs, has the added advantage of testing an automatic mechanism by which the Treasury does not accept any bids which are too distant from the market-determined average. This method reconciles the need to insure the necessary flexibility of BOT yields, and indirectly to support the CCT market, with that of not accepting anomalous bids at auction. However, the listing of BOTs on the screen-based market would be the best way to assure a more regular auction process.

4. Market information and distribution

Information problems arise at various levels.

A correct and mutually advantageous relationship with the market may require planning and the announcement in advance of the issuing strategies, and more frequent contact between the institutions and the operators. We note further that other countries have developed marketing techniques which are still foreign to us. Marketing first requires full information on the characteristics and the advantages of the new instruments introduced by the issuer. In other countries, the reforms and the innovations in debt management have been widely publicized, in advance, among both operators (domestic and international) and savers. This is particularly relevant in the Italian case because of the increasing share of government securities in households' portfolios (while holdings in the portfolios of institutional investors, banks and investment funds decline) and of the potential role of foreign institutional investors. In practice, this means that innovations concerning new securities, or different methods of issue must be preceded by the publication of illustrative "prospectuses" containing exhaustive and detailed information, similar to what is already requested of companies. The absence of reliable information — often replaced by rumours and hearsay — increases market uneasiness and therefore leads to the perception of additional risks. Removing these constraints is clearly in the issuer's best interest.

Closer attention should also be paid to the "advertising" aspect, especially for the new types of securities, but more generally on

investment in government securities. It seems possible — within the strict guidelines imposed by the accuracy of information — to carry out a more modern and probably more effective advertising activity. Improvements may be directed at the messages (for instance, a comparison between *ex post* yields obtained on government securities and those realized on other financial assets in past years), or the means (such as television media, for example). A thorough analysis can assess whether the transition to more modern advertising techniques than those employed up to now — and better suited to the great amounts of “product” to be mass-distributed — can provide benefits (in terms of increased stability of demand) greater than their costs. Information and marketing must also involve the retail distribution of securities, which at the moment is still concentrated with the banks. On this subject, the role of underwriting fees should be reconsidered: the fees could be variable according to types of securities (being greater for the new securities) and according to the distribution effort of the underwriter.

To this end, the highly structured Post Office system could be better used for public debt management. Besides collecting traditional Post Office savings (which in turn could be encouraged by introducing some innovations, such as the issuing of Postal Office real yield-bearing certificates), Post Office branches could also be entrusted with the sale of certain types of government securities.

To promote distribution, the possibility of using investment fund networks to place government securities through appropriate agreements should also be considered.

Finally, there is an area in which “distribution” innovations and “product” innovations overlap. “Contractual investment accumulation plans” in government securities (through the banking and Post Office channels and possibly the investment fund networks) are a case in point. They would help increase the demand for government securities, interest rates being equal, and make it more predictable, since the underwriting commitments at the specified dates would be known in advance.

In conclusion, we note that at the beginning of the year the Treasury Minister, aware of the information problems, announced the preparation of a handbook illustrating the characteristics of Italian government securities and of their market: we would thus follow the excellent example of the French Treasury which, in cooperation with the market makers, has published a handbook in

English. The Minister's intention has not yet translated into concrete results.

V - Institutional and organizational aspects of debt management

In the preceding sections we have attempted to demonstrate the importance of a debt policy, for which the Treasury is responsible, even within the framework of necessary coordination with the Central Bank. We have seen that an effective management policy requires innovations which adapt to the development of the markets, analysis and monitoring of market conditions, gathering and diffusion of information, and willingness to remove, by administrative and legislative interventions, some obstacles threatening efficiency and serving no purpose. Managing the public debt is a full-time job, to which the debtor, especially a large debtor, must devote appropriate structures and resources.

This section will examine whether the debt management situation in Italy satisfies these requirements.

1. *The role of Parliament*

Within the Italian framework, the institutions involved in decisionmaking with respect to debt management are the Parliament, the Treasury, and the Bank of Italy.

In section II the links between debt management policy and monetary policy were examined. The focus was on the need to strengthen institutions for coordination, in view of increasing the autonomy for both the Treasury and the Bank of Italy, which respectively would assume full responsibility for public debt policy and monetary policy.

As far as the links between the Parliament and the Treasury are concerned, during the last ten years the role of Parliament has often changed, and with it the responsibilities of the Treasury Minister with regard to public debt policy.

Law no. 468 dated August 5, 1978 set constraints to the borrowing policy, which previously had largely been the result of

legislation authorizing in each case the recourse to the market: the budget then merely reflected previous decisions to issue debt, and expenditure depended on actual borrowing. This presented advantages and disadvantages; formally, the Parliament was responsible for determining public debt policy; the Treasury Minister could delay expenditure by delaying the issue of debt; as indebtedness had to precede expenditures, undesired cyclical effects could occur as a result.

The 1978 law requires instead that the budget record the projected revenues from borrowing, so that budget expenditures are no longer linked to actual borrowing. The budget law must set the maximum level of recourse to the financial market for each year (a similar proviso exists for the multi-year budget). This means that both budget indebtedness and other available forms of financing are included in the overall State borrowing requirement. However, this more unified decisionmaking process is hampered by the fact that the "net balance to be financed" is set in terms of appropriations rather than of actual realized flows.

Law no. 119 dated March 30, 1981 (budget law for 1981) disciplined State indebtedness by stipulating that each year limits be set to the issue of BTPs, CCTs, securities in ECU and real-indexation securities, as well as of BOTs (for which both net issues and the amount in circulation should be determined). Since recourse to the Treasury overdraft facility and to advances from the Bank of Italy above the overdraft limit are already regulated by law, only Post Office savings can increase during the year without a preset limit.

Finally, *Law no. 362 dated August 23, 1988*, which amends both of the previous laws, removed the specific ceiling on BOT issues and required the yearly approval of the maximum amount of net public-sector issues (in Italy and abroad), taking into account the State-sector borrowing requirement determined according to budget cash estimates and Treasury flow valuations.

The development of legislation governing the public debt has therefore gone in two directions: on the one hand, it has made the constraints on overall indebtedness more general and explicit, while on the other hand it has increased the Treasury Minister's authority to decide on public debt policy and on the features of the securities issued (as all the legislative constraints on maturities have been relaxed).

2. Organization of the Treasury Ministry

If the Treasury is to assume full responsibility for managing the debt, it becomes even more necessary to improve the Ministry's administrative structures for debt management and the related decisionmaking procedures.

The inadequacy of the current administrative structures to deal appropriately with the changes in the public debt situation, the limited operational ability of the offices in charge of the related tasks, the presence of redundancies and overlap, and the lack of "coordination which would guarantee the necessary consistency of evaluations and of purpose in all preliminary activity contributing to the decisions of the Minister", are all negative aspects of the present situation recognized in the Government's presentation of a bill (DDL no. 1771 19-5-1989) concerning changes in the organization of the Treasury Ministry and aimed at remedying the current failings.

This unsatisfactory situation is as much the result of the historical development of administrative structures within the Ministry and of their inability to adapt to the new tasks required by changes in the size and structure of the debt, as it is the consequence of the gradually accepted practice regarding responsibilities and procedures.

The current division of responsibilities among the various administrative structures in the Treasury Ministry dates back to a time when the budget was generally balanced, and the distinction between short-term debt, managed by the Direzione Generale del Tesoro (Directorate General of Treasury, D.G.T.), and long-term debt, managed by the Direzione del Debito Pubblico (Directorate of Public Debt), reflected a distinction between non-interchangeable liabilities. Subsequently, profound changes in both the budget situation and the approach to financing have increased the responsibilities of the Direzione del Tesoro, especially in decisionmaking, while the role of the Direzione del Debito Pubblico has been cut down to merely administrative management. Recently there was a phase in which the Direzione del Debito became more concerned with decisionmaking, and its organization changed in this direction. However, this caused several coordination problems to surface; the Treasury Ministry reform bill referred to above is an attempt to solve such problems.

Originally, the task of the Direzione Generale del Debito

Pubblico was to manage the debt pertaining to the State budget, which was all medium- and long-term debt. Later, however, it was denied responsibility for CCTs or CTEs as at the end of the 1970s it became clear that it was appropriate to head toward concentrated decisionmaking. Since the Direzione Generale del Tesoro was entrusted with managing the BOTs, it was thought logical that it assume responsibility for securities indexed to BOTs; and since it was entrusted with the management of foreign financial relations, it was considered the best equipped agency for handling foreign-currency-denominated securities.

Even with its responsibilities thus limited, the Direzione del Debito Pubblico in recent years tried to assume the role of "Research Centre" on the public debt — a role which was not performed anywhere within the Ministry.

The responsibilities of the Direzione Generale del Tesoro regarding public debt mainly involve the management of the department (Tesoreria), which issues BOTs, manages the current account with the Bank of Italy, and also manages, together with other current accounts of public agencies, that of the Deposits and Loans Fund (Cassa Depositi e Prestiti), on which Post Office savings flowing to the Treasury are deposited. In particular, the duties of Division V of the D.G.T. are the "issue and management of BOTs, forecasting of cash requirements and compilation of the daily cash position, functions related to the Tesoreria". The overwhelming importance of the Tesoreria in matters related to Treasury financing is shown by the fact that for many years its head has been a Dirigente Generale (a top manager) with specific personal responsibilities delegated by the Direttore Generale del Tesoro (Director General of Treasury), regarding the forecasting of cash requirements and the preparation of proposals for financing.

External debt is instead the responsibility of Division XVIII as the one generally responsible for foreign exchange matters.

Two separate Divisions of the D.G.T. are responsible for the issue and management of CCTs.

Finally, Division I is broadly entrusted with the task of analyzing and studying "problems concerning public finances, and public debt in particular", which leads to the production of a sizeable amount of statistical data. There are economic advisors to the Direttore Generale del Tesoro, but they do not seem to carry out with any regularity preparatory work regarding the issues of public debt.

The contribution of the Post Office system to the financing of the deficit is given by the difference between the savings flowing to the system and the loans made by the Cassa Depositi e Prestiti. Post Office savings either are invested in securities issued on tap or go into deposits: the interest rates, on which savings flowing to the system depend, are set by Treasury Minister decree, on the recommendation of the Board of Directors of the Cassa.

The State General Accounting Office (Ragioneria Generale dello Stato) has no responsibilities regarding the debt. It is, however, responsible for the interest expenditure of the public sector, of the State sector and of the State budget.

The forecasting documents do not specify the assumptions regarding interest rates and the structure of financing on which these forecasts are based: the assumptions are frequently changed and appear to be the result of informal consultations with the Bank of Italy and the Direzione del Tesoro. Up to now the only department of the Ragioneria in charge of handling this problem was the Budget Inspectorate (Ispettorato del Bilancio); the recent creation of an Inspectorate for Public Sector Accounts (Ispettorato per i Conti del Settore Pubblico) could mean the emergence of yet another department concerned with public debt problems.

3. Weaknesses of the organization

This distribution of responsibilities among various sectors of the Administration does not seem either to insure a rational division of duties, or to satisfy specialization requirements. In any case, such a fragmented division of responsibilities would require effective coordination. But as no agency within the Ministry appears to be in charge of this task, the responsibility for coordinating the decisions concerning financing policy falls upon the Treasury Minister himself. The Minister, however, is not supported by any structure organized specifically to carry out this activity, or even to provide a preliminary analysis: the existence of economic counsellors within the Minister's Cabinet is not enough, also because of the imprecise definition of the counsellors' role within the ministerial structures.

This situation affects the decision process regarding debt management. At present, the decisions as to the timing and the characteristics of the various issues are based on the forecast of the annual and monthly borrowing requirements.

At the annual level, a more reliable forecast of the State-sector borrowing requirement than that of the Government Economic Planning Report is set out in the Quarterly Report on the public-sector cash requirement estimates, which presents quarterly outcomes and updates the forecast for the year. At the monthly level, there is a forecast by the Direzione Generale del Tesoro. In actual fact, debt policy is decided to a large extent on a monthly basis, partly because the interest expenditure forecasts of the reports are not linked to the actual management of the debt.

The monthly forecast prepared by Division V of the Direzione Generale del Tesoro at the beginning of the month is an internal document, and is not made public. The forecast is an exercise in guesswork, since it concerns phenomena which are not under the Treasury's control, and highly volatile variables, while the offices are not equipped to collect timely information on their behaviour.

The difficulties in forecasting monthly borrowing requirements have always caused problems for debt management as well as for the Bank of Italy and for market operators. In general, the forecasts have a bias towards overstating the borrowing requirement, with highly variable and non-systematic discrepancies between forecasts and outcomes.

The consequences of errors in the forecasting of the monthly borrowing requirement cannot be overlooked. The Treasury issues more securities (or fewer securities) than requested to absorb the liquidity created by its deficit. The market finds it more difficult to plan its behaviour. The Central Bank may at times be led to intervene in the monetary market on the basis of incomplete or inaccurate information, even though it prepares its own independent estimate of monthly and annual borrowing requirements.

On the basis of the forecast, a proposal as to the instruments to be issued to meet the financing need is put forward. This is divided into ten-day periods, since issues take place more than once each month and an attempt is made to match the creation of liquidity with its absorption. Obviously, the process of matching is carried out not only by appropriately timing the issues, but also by adjusting the borrowing requirement, within the limits allowed by the flexibility of certain expenditure items.

The decisions taken concern the distribution of issues over the month and are reviewed in the light of the outcome of each placement. Only short-term considerations, such as the monthly

borrowing requirement and the possible short-run changes of the debt structure, inspire the ministerial decrees concerning the issues.

The forecast of the borrowing requirement and the proposal for its financing by the offices of the Direzione Generale del Tesoro are followed by consultations with the Bank of Italy: at the end, the latter submits to the Minister one or more case-by-case written proposals on monthly issues and on the types and the characteristics of the individual issues. Only for very brief periods has this consultation phase been institutionalized in joint working groups.

4. The necessary changes

The shortcomings in the organizational structures and in the decisionmaking process unavoidably have a negative influence on the management of the public debt. A summary list of these shortcomings helps to formulate a few suggestions aimed at improving debt management.

Firstly, there is no agency entrusted with the responsibility of forecasting the borrowing requirement, by making use of the information on management of the budget and of other Treasury cash flows, in the framework of broader financial and economic considerations. Such an agency should also be responsible for preparing medium-term forecasts. Further, there is no agency solely responsible for longer-term proposals on recourse to the available financing instruments. Finally the Minister lacks a support structure, which could take the form either of a joint committee of the directors of the various branches involved, or of a council of experts which the Minister's Cabinet has authorized to interact with the offices.

None of these requirements can be completely fulfilled without new legislation on the organization of the Ministry. The draft bill presented last May to modify the structure of the Treasury Ministry does not seem to provide a full and satisfactory answer to the problems mentioned here, although it is a first step toward a reorganization of the Ministry's functions. Moreover, it is difficult to predict how much time will be needed for its debate and approval, as issues regarding the organization of the public-sector machine seem to send the decisionmaking process into a state of near total paralysis.

Even before the approval of the draft bill presented by the

Government, possibly in an improved version which could better fulfill the above requirements, some changes in organization could be implemented in view of improving the management of the supply of government securities.

This reorganization should be aimed at:

1. increasing the coordination of the various offices involved at different stages in the preparation of the issuing proposals: for example, by once again forming a joint group of representatives of ministerial offices and of the Bank of Italy, with clearly defined tasks concerning the forecasting of borrowing requirements, the means of financing, and the characteristics of individual issues. The group could also be responsible for preparing medium-term (or at least three-month) issuing schedules to be updated periodically;

2. increasing the information content of the preliminary phase leading to the draft proposal for each issue: for example, by strengthening the structures of the Council of Experts (as well as those of the offices) of the Direzione Generale del Tesoro, which could be entrusted with the gathering, preparation and systematic analysis of the relevant information for debt management, both for each individual issue, and with reference to the overall issues forecast in the medium-term plan, and which could entertain a more systematic and timely exchange of information with the Bank of Italy;

3. increasing the focus on the market: by improving the communication and publicity of issuing schedules and of single issues (especially when a change of policy occurs, or when innovations and changes are introduced); by intensifying contact and exchange of information with qualified Italian and foreign operators in a clearly defined and appropriate setting; by periodically supplying technical evaluations and detailed information on public finance trends and policies; by making an effective effort to overcome the practical obstacles which sometimes hinder the performance of the market for government securities.