Monetary Policy in Italy: the Limited Role of Monetarism

1. Introduction

" Monetary theory is less abstract than most economic theory; it cannot avoid a relation to reality, which in other economic theory is sometimes missing ". This judgement by Hicks[1] is substantiated by two circumstances. In the first place, there is the topicality of monetary theory, i.e., the fact that monetary analysis is designed to clarify specific current problems. In the second place, there is the constant evolution of money over time, and, in a more general perspective, the development of the financial system. As Hicks further observes, " in a world of banks and insurance companies, money markets and stock exchanges, money is quite a different thing from what it was before these institutions came into being ".[2] This evolution of the financial institutions has profoundly modified the way in which the financial system functions and has called for continuous revisions of monetary theory.

Hicks' reflections can *a fortiori* be extended to monetary policy, whose role and *modus operandi* therefore depend, not only on current problems and on the existing institutional pattern, but also on the way in which these aspects are interpreted by monetary analysis. But monetary analysis sometimes adjusts to the evolution of the monetary system with a certain time lag and does not respond immediately to current problems. To that extent, the decisions on monetary policy are affected thereby. For, in that case, the definition of the objectives and the choice of instruments of monetary policy are bound to be based on inadequate analytical models.

In this context, there is still a third aspect to be borne in mind. If it is true that monetary policy — and hence the importance

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1 J. R. Hicks, " Monetary Theory and History, an Attempt at Perspective ", in *Critical Essays in Monetary Theory*, Oxford, 1967, p. 156.
2 *Ibid.*, p. 158.

of that policy — depends in the first instance on the analysis adopted by the authorities and on their value judgements, the authorities' choices and behaviour in their turn are not independent of the prevailing judgements and opinions.[3]

In this connection, a particularly appropriate example is that of the impact on central banks — and hence on monetary policy — of " monetarism ". As we all know, this " school " selects the stock of money, as the indicator and target of the monetary authorities operations. In recent years, there has, in a number of countries, been a gradual conversion of the monetary authorities to monetarism, in response to the diffusion — even among public opinion — of the conviction that the monetary authorities controlled, or should have controlled, the rate of growth of the money supply. For, if it is generally held that the monetary authorities must control a certain variable, they are obliged to do so. Should they fail to do so, the expectations of the public are adversely affected, and this can destabilize the system, and in any case reduce the degree of control exercised by the monetary authorities.[4]

In order to assess the role of monetary policy, we must therefore take account, not only of the objectives and instruments of the Central Bank, but also of the objectives and instruments which it is generally held that the Bank should adopt, and more specifically the interaction of these two factors.

In the following analysis, we seek to apply these criteria to the case of Italy. We shall first of all provide an overall definition of the operational indications arising out of monetarism, and we shall then compare them with the objectives and strategies of Italian monetary policy. It will appear that, in recent years, despite the diffusion of the monetarist theses, the Bank of Italy's analysis and strategy have been moving in the opposite direction. If, up to the

[3] With specific reference to the Bank of Canada, emphasis has been laid on the influence on the Central Bank's choices (as regards objectives, indicators and instruments) of the priorities expressed by those power groups in a position to influence the status of the Central Bank. See J. F. CHANT - K. ACHESON, " Bureaucratic Theory and the Choice of Central Bank Goals ", *Journal of Money, Credit and Banking*, May 1973, pp. 637-55. In reality, this thesis can be expanded to mean that the public's expectations influence the choices of the Central Bank.

[4] This also means that, if the monetary authorities very emphatically announce their objectives — for example, a certain expansion of total domestic credit — their action may have negative consequences if that value is not attained. If, during the target period, there are new developments which induce the authorities to modify their target, they are obliged to offer a public justification in order to avoid giving economic operators the impression that the authorities have lost control of the situation.

middle of the 'sixties, Italian monetary policy stressed the volume of the *economy's liquidity*, in subsequent years the emphasis was gradually switched to the creation of *total financial assets and liabilities*, thus reducing the role played by the stock of money (a variable which almost ceased to be even mentioned). To conclude, we shall seek to assess how far this evolution is justified by the corresponding evolution of the financial system and by the problems which the monetary authorities have had to deal with in the last few years.

2. The Role of Monetary Policy[5]

Friedman — who, despite the subsequent variegated development of monetarism, is still rightly regarded as its leading authority — is fond of quoting a passage from John Stuart Mill as the starting point of his studies on the role of monetary policy: " there cannot be intrinsically a more insignificant thing, in the economy of society, than money; ... it only exerts a distinct and independent influence of its own when it gets out of order ".[6] This concept is therefore linked with Friedman's judgement that the main aim of monetary policy should be to prevent monetary variables from imparting destabilizing stimuli to the economy.

In particular, there are two things which monetary policy should avoid, because they might lead to " perverse " results:

i) trying to reduce the rate of interest below its " natural " value; because (through an expansionary monetary policy and the increase in prices connected therewith) the only result would be an increase in the nominal rate of interest; and

ii) trying to reduce the rate of unemployment below its " natural " value, because the result would again be only an increasing rise in prices.

If these are the two objectives which the monetary authorities ought to avoid, which are the ones which they ought to endorse? In the first place, as we have already seen, they should not destabilize

[5] From the title of Friedman's essay, published in *The American Economic Review*, March 1968, pp. 1-17. Despite the subsequent developments of monetarism, this essay is still the basis of the theory.

[6] *Ibid.*, p. 12.

the economic system; which means that they should not adopt unrealizable objectives and yet avoid sharp swings in the evolution of the monetary variables.[7] In the second place, they should help to offset the main disturbances in the economic system stemming from other sources; but here, too, they should act with the greatest caution, since our knowledge is insufficient to guarantee that their action will be effective and their intervention prompt enough.[8] If the authorities are to succeed in these tasks, it is essential that they should adopt as the indicator and target of their policy a variable over which they have control, and that variable is the money supply. For monetary policy influences the *real* variables, but not in a definite and stable way. In other words, it does not control them. It controls only *nominal* variables, and, with the greatest precision, the money supply.

This synthesis of the monetarist theses which go back to over ten years ago, but still have numerous supporters, obviously implies a highly negative judgement on the monetary policies of numerous countries — including Italy — in the postwar years. A judgement which contrasts with that of, for example, two OECD economists who recently began a review of the operations of monetary policy with the following affirmation: " Monetary policy has played a prominent and increasing role in stabilization policies in most industrial countries over the past 15 years. An important reason for this has been a growing confidence that monetary policy does have significant effects on total demand and thereby on the level of employment and the rate of increase in prices; in this respect, thinking in Central Banks has been reinforced by the results of theoretical and empirical research ".[9]

Before we confront the monetarist theses with the position in Italy as regards the objectives and strategy of monetary policy, we should clarify the analytical context of Friedman's conclusions. As we have observed, this assumes the existence of a " natural " rate of interest and of unemployment which are not influenced by monetary

7 It is interesting to note in this connection that Friedman's theses link up more directly with the position of other classical economists such as Hume and Ricardo than with the position of Stuart Mill. See J. R. Hicks, *op. cit.*, pp. 159-67. The proposal that the money supply should expand at a steady rate of growth is extraneous to Stuart Mill's analysis and closer to that of Ricardo.

8 We must therefore exclude the " fine tuning " strategies which seek to achieve excessively short-term objectives.

9 K. Shigehara - N. Thygesen, " The Effects and the Design of Monetary Policy " in F. Masera - A. Fazio - T. Padoa Schioppa (Eds.), *Econometric Research in European Central Banks*, Bank of Italy, Rome, 1975, p. 107.

policy. This concept is explicitly defined in the context of a situation of *general equilibrium*. Now we know that the economic system is never exactly in such a situation, but we can still usefully turn to a theory of equilibrium to the extent to which we regard the system as *stable*, that is, which tends to attain equilibrium. In other words, at every moment, the system will be in a certain point around the equilibrium position, and, since the equilibrium position itself changes over time, the long-term trend of the system will identify the equilibrium position. Hence, in a system which we take as being stable, its long-run trends can be analyzed as equilibrium situations (even if at no point the economy has ever been in equilibrium).

In fact, many of the analytical propositions of the monetarists have been verified on the basis of the hypothesis that the economic system is stable and that monetary policy has no influence on the equilibrium position (which is determined on the contrary by the " real forces "). Hence, the conclusion that monetary policy has only an initial impact on the level of employment and interest — an effect which is gradually reabsorbed — possibly by a process of cyclical adjustment — as the system reverts to its previous equilibrium position. In the long run, monetary policy has no real effects. It does have them in the short run, but these risk destabilizing the economy.

This emphasis on the effects of monetary policy, measured in terms of long-run equilibrium, is common to the different variants of monetarism which have emerged most recently and which, in the past few years, have come into fashion in Italy too.

A first variant — already emphasized by Friedman — involves budget policy depending on the ways in which public expenditure is financed, and is known as the *crowding-out* effect. In its more simplified version, it affirms that an increase in public expenditure, not financed by money, has no effect on real income, if the effect is measured in terms of long-run equilibrium.[10] This corresponds in general to the hypothesis that the increased public expenditure — financed by bonds sold to the public or by sums raised by taxation — effects a corresponding reduction on private expenditure. Hence, in the long run,[11] not even budget policy can affect the

10 See K. M. Carlson - R. W. Spencer, " Crowding-out and Its Critics ", *Federal Reserve Bank of St. Louis Review*, December 1975, pp. 1-17.

11 It should be noted, however, that this long-term analysis is in reality carried out with short-term models whose solution is calculated for several successive periods. Thus, it does not take due account of the direct effects (whether positive or negative) of public expenditure on the rate of growth of productivity, and so on.

equilibrium level of income. Public expenditure replaces private spending, while private savings remain unchanged. If the increased public expenditure is financed by taxation, this means that there is a corresponding reduction in private consumption. If it is financed from bonds, this means that, in the private portfolios, these public bonds replace financial liabilities of private firms corresponding to their smaller investments. The crowding-out effect has usually been explained in terms of interest elasticity of IS-LM curves (even if Friedman objects to this presentation). The case of *ex ante* crowding-out, however, has also been put forward, because of the fact that ultrarational households regard the corporate and public sectors as an extension of themselves, i.e., as instruments of their private interests. Thus, they are indifferent to whether consumption and investment are provided through the public or private sectors.[12]

A further variant, known as the " New Cambridge School ", assumes that the stability of the private sector does not relate solely to savings, but to the financial surplus of the sector itself. Once the process of adjustment has operated — the economists of the Department of Applied Economics at Cambridge maintain — the private sector (Households and Firms) spends on consumption and investments a high and stable proportion of its disposable income. If the public sector has a financial deficit (i.e., spends more than what it detracts from the private sector by taxation) and offers the private sector a volume of financial assets greater than that demanded by that sector, the excess flows off abroad and gives rise to an equivalent deficit in the balance of payments on current account.

Again, in its simplified version,[13] this even means that the manner in which the public deficit is financed is irrelevant. The private sector has a stable aggregate demand for net financial assets;

[12] See P. A. DAVID - J. L. SCADDING, " Private Savings: Ultrarationality, Aggregation, and 'Denison's Law' ", *Journal of Political Economy*, March-April 1974, pp. 225-49. This thesis could be further expanded to include the case in which the extension of the public sector " at the expense " of the private sector corresponds to the preferences of the private sector, however irrational these preferences may be.

[13] In reality, in its last version, account is taken of the fact that there is " money illusion ", and hence, when there is inflation, the financial investment of the private sector increases. In addition, monetary policy appears indirectly since changes in the value of stocks (financed by bank borrowing, but it is stated that this occurs " more or less automatically "!), bank advances and consumer hire purchase debt have a negative influence on the net acquisition of financial assets by the private sector. Hence, a policy of financial restriction can lead to an increase in the financial surplus of the private sector and reduce the foreign deficit offsetting a given deficit in the public sector. See F. CRIPPS - M. FETHERSTON - W. GODLEY, " What is Left of 'New Cambridge'? ", *Economic Policy Review*, March 1976, pp. 45-9.

whether the public deficit is financed by money or by bonds makes no difference.

There is, lastly, a third variant, in the case of an open economy of reduced dimensions and firmly integrated in the world economy, known as the " monetary approach to balance-of-payments theory ", according to which the whole balance of payments (current account and capital movements) is determined by the equilibrium between the demand for and the supply of money. Given a certain demand for money, an excessive supply flows off abroad (by the purchase of goods and financial assets) and is recorded by an equivalent deficit in the balance of payments. In this case, fiscal policy in the strict sense of the word (i.e., which does not involve variations in the money supply) may have domestic effects without any repercussions on foreign accounts.

It clearly goes beyond the scope of these notes to make a complete analysis of these different models or to verify their logical consistency and the empirical reliability, and hence to make an exhaustive assessment of them.[14] However, we can in general observe that these represent the reaction — at the academic level, but that has already begun to produce practical effects — to a naive and optimistic Keynesian model according to which — setting aside all the factors of instability, uncertainty and pessimism, which are yet essential in Keynesian theory — aggregate monetary and fiscal policies could have guaranteed us the attainment of any desired combination of the main objectives — stable and increasing income with full employment, foreign equilibrium and stability of prices.

As an alternative approach, insistence on long-term equilibrium conditions should induce the monetary authorities to avoid defining their interventions on the basis of time horizons of a few months.

[14] In recent years, a copious literature has appeared on this issue, both at the theoretical and the empirical level. At the empirical level, the most significant contribution to the problem of *crowding-out* is by F. MODIGLIANI - A. ANDO - J. GIANGRANDE, " Impacts of Fiscal Actions on Aggregate Income and the Monetarist Controversy: Theory and Evidence ", in J. L. Stein (Ed.), *Monetarism*, Amsterdam, 1976, pp. 17-42. Their conclusion is that a bond-financed increase in government expenditures has significant effects for several quarters. This is enough for a stabilization policy. At the theoretical level, the theory that there is crowding-out in long-run equilibrium has been rejected with the argument that this would not be consistent with the assumption of the stability of the economic system. See A. S. BLINDER - R. M. SOLOW, " Does Fiscal Policy Matter? ", *Journal of Public Economics*, November 1973, pp. 319-37. For a first analysis of these different variants of monetarism applied to Italy, see my " Credito totale interno e offerta di moneta ", *Rivista internazionale di scienze sociali*, September-December 1975, pp. 563-95.

The emphasis on integration in the world economy ought to remind us of the limited sovereignty which it involves, and hence of the impossibility of successfully pursuing policies aiming at objectives which diverge too sharply from those of the other countries. The accent on the public sector deficit ought to bring out the impossibility — always with reference to the longer than short-run — of continuing to mediate between requests which are otherwise incompatible on the part of various social groups and classes by offloading the additional burden on to public finances.

This does not of course mean that each of these models — which, incidentally, are not necessarily mutually incompatible [15] — is valid at the present time for the Italian economy. For example, even if we think that in certain conditions an increase in public expenditure leads to a reduction in private expenditure, it is not certain that the converse is true, that is, that a corresponding increase in private expenditure is guaranteed if there is a reduction in public expenditure.[16]

These considerations, however, are sufficient to provide a general frame of reference within which we can examine the objectives and the strategies of Italian monetary policy.[17]

3. The Objectives of Italian Monetary Policy

In the first place, what objectives have the Italian monetary authorities regarded as being most important? The reply can be obtained in various ways. The main ones are these:

[15] In particular, the " New Cambridge " is not compatible with the operation of *crowding-out* effects.

[16] Among other things, the institutional criterion for drawing a boundary between public and private expenditure proves to be increasingly inadequate, especially if an increasing proportion of public expenditure represents transfers to the private sector. From this point of view, a step forward on the analytical plane has been taken with the criterion based on *market* and *non-market* sectors. See R. Bacon-W. Eltis, *Britain's Economic Problem: Too Few Producers*, London, 1976.

[17] In general, in the Bank of Italy's analyses, the above models are hardly sketched in, and in any case in versions which reduce their monetarist nature. For example, the definition of crowding-out is as follows: " If it were desired to restore external equilibrium without having to pass through a higher degree of inflation, the financing of the Treasury deficit should have been effected by the issue of securities placed with the public, the banking system or with both to the extent needed to enable resort to the Bank of Italy to be reduced by about half; the volume of credit channelled to firms by the banking system would have been several thousands of billion lire less than was actually the case. Had that been done, the balance between demand and supply would have been restored by restricting demand on the investment side. " Bank of Italy, *Report for 1973*, p. 420. It will be noted that no difference is made between sales of public securities to households or to banks, and that the transmission mechanism is identified as the bank credit offered to firms.

i) to stick to the official statements;

ii) to deduce the objectives by rationalizing *ex post* the policy pursued by them.

This second method, which is more elegant from the analytical point of view, presents considerable problems of definition and estimation. We should first of all know the effects of monetary policy in order to derive therefrom the authorities' aims. But, to the extent to which the evolution of the economy incorporates the effects of monetary policy, and these effects depend on the aims of the authorities, we cannot make an independent estimate of the aims " revealed " by the authorities.

Let us then be content to reread the Bank of Italy's declarations on its objectives. If we consult the Bank of Italy's *Reports* — and in particular the Governor's *Concluding Remarks* — of the last twenty years, it seems to me that the clearest, most complete and most authoritative definition of the objectives of monetary policy is the one supplied by the Governor of the Bank in 1964-5 (Guido Carli). According to Carli, the *two main responsibilities of monetary policy* are: *to maintain equilibrium in external payments, and to encourage the formation of saving and control the flow of credit towards investment.*[18] This statement is qualified by the observation that *if* the first objective has to be pursued under the condition of a stable rate of exchange, the second one must be pursued *in such a way as to maintain a certain degree of domestic price stability.*[19] Carli had also clarified that, when domestic and external objectives conflict, it soon becomes obvious that it is essential to assign monetary policy to the balance of payments and leave to budget policy the responsibility for seeing to domestic objectives.[20]

This formulation — two objectives, one constraint and a criterion of priority between the objectives — is probably even today the one which provides the best explanation of the behaviour of the Italian monetary authorities in the last fifteen years.

We can already note in it certain anomalies with respect to the monetarist theses set out above. Price stability is not an objective *per se*, but a necessary condition for the balance of payments to achieve equilibrium with a stable rate of exchange. And that ex-

[18] Bank of Italy, *Report for 1964*, p. 459.

[19] *Ibid.*, p. 460.

[20] Bank of Italy, *Report for 1963*, p. 485.

plains the present preoccupation with the maintenance of the current levels of the lira if Italian prices continue to increase at rates above those of their foreign competitors. More generally, it explains why the traditional objective of stable prices is now being redefined in terms of a rate of inflation equal to the average for the other industrial countries.

Moreover, if the first objective is defined in terms of equilibrium of the balance of payments, the second objective is defined in much more specific terms — *control the flow of credit towards investment.* And this, too, is in contrast with the monetarist theses, according to which what counts is the amount of money and not the financing for specific components of aggregate demand.

4. The Strategies of Italian Monetary Policy

It is clear from the identification of these two objectives — external equilibrium and financing of investment — that there are two strategies of monetary policy which Italian monetary authorities have tried to carry out, and wherever possible to reconcile.

The first strategy is effected at the level of financial balances, and hence can be defined — in aggregate terms — as the compatibility of the financing of the public deficit and of investments, given a certain volume of private saving, with an objective for the current balance of payments. Even if the analysis is verified at a disaggregated level — of single components (assets and liabilities) of the financial flows, for a certain period — the perspective is still a macro-economic one, and leads to the identification of a certain volume of *total domestic credit* which, given the overall demand for financial assets by the private sector, determines, in equilibrium, the desired value for the current account. From this aggregate point of view, once the value of total domestic credit compatible with the desired balance of the current account is fixed, its main components are substitutable within the total credit and in particular the finance to the private and public sectors.

However, the Italian monetary authorities are not indifferent among the various components of total credit. They do not, in other words, accept an analysis carried out solely on the private sector's portfolio side in terms of substitutability between the total of financial assets and the total of real assets. The authorities also set themselves

other objectives for the allocation of resources, and, in line with these, follow strategies for the allocation of credit, and, more in general, for the regulation of the structure of financial flows.

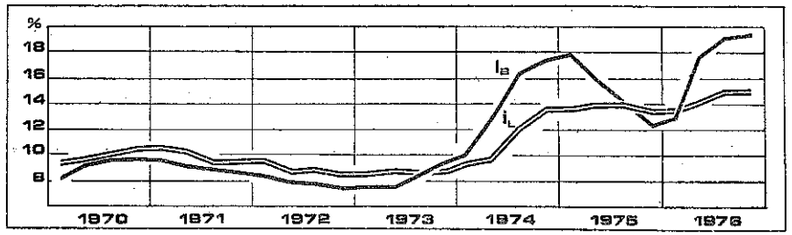
Thus, the first strategy is formulated in terms of *volume* of total credit (to which there corresponds a certain level of the rate of interest), while the second strategy is defined in terms of *structure* of the total credit (to which there corresponds a certain structure of the rates of interest). To the extent to which monetary policy really succeeds in splitting itself into two independent strategies, it is also possible for it to pursue at the same time two distinct objectives — level *and* composition of aggregate demand; and hence, for example, to seek to balance foreign accounts, minimizing their impact on investment.

We have said " to the extent to which ", because obviously the possibility of orienting the allocation of the financial flows depends both on the existing financial institutions and on the economic-financial conditions of the moment. In other words, a selective credit policy, like policies for the regulation of the structure of interest rates, assumes that there is a reduced substitutability between the different financial liabilities, and that these will be oriented towards the financing of specific components of aggregate demand. This depends on the existing structure of the financial intermediaries and on the functioning of the financial markets, and still depends on the evolution of the economy.[21]

How important in actual fact is this possibility for the Central Bank to succeed in orienting the flows of credit and thus regulating the allocation of resources? For Italy, we still lack detailed analyses of the *specificity* of the various types of financing, of their reduced substitutability and so on. However, experience shows that the monetary authorities assign importance to them, and that, on numerous occasions, they have had recourse to credit policies — designed to regulate the structure of credit — rather than to monetary policies — aimed at regulating the total of credit. In this connection, the experience in 1973 is typical when a series of selective interventions aimed at reducing the growth of bank credit and expanding the credit of non-banking institutions, on the hypothesis that

[21] For an " efficient " assignment of the two strategies to the two objectives, it is also essential that their effects have an appropriate temporal profile. There would be " perverse " results if aggregate short-term strategies produced mainly long-term effects and vice versa.

the former was financing the purchase of stocks and financial assets abroad, while the latter financed productive investments.[22] In a more general perspective, in recent years the term structure of the rates of interest has provided a continuous point of reference for the action of the monetary authorities, and its evolution over time — see the Chart for the period 1970-76 — must be regarded as an important indicator not only of the expansionist trend in monetary policy but also of its sectoral objectives.



i_B = interest rate on bank loans; i_L = interest rate on long-term loans supplied by special credit institutions. *Source*: BANK OF ITALY, *Report* for various years.

5. The Analysis at the Basis of Italian Monetary Policy

If neither the objectives nor the strategy of Italian monetary policy are monetarist, neither, obviously, is the analysis underlying them.

Two points in particular have been repeatedly emphasized in the Bank of Italy's *Reports*. In the first place, stress was laid (in recent years as well)[23] on the relative unimportance, as an indicator and target of monetary policy, of the supply of money by itself. This can, at first sight, cause some surprise if it is remembered that in Italy liquid assets form a particularly high proportion of total financial assets of the private sector, reflecting the dominating position of the banks among financial intermediaries. However, it would appear that the interest elasticity of the demand for money is high and unstable,

22 In this connection, see my " I controlli selettivi del credito ", *Rivista internazionale di scienze sociali*, January-April 1975, pp. 55-82. The same reasoning has been used for 1977: " a mobility of the short-term rates higher than that of long-term ones is desirable. It is preferable to obtain a given effect on domestic demand and on the balance of payments, acting on stocks and commercial credits abroad rather than on plant and equipment. " See BANK OF ITALY, *Report for 1976*, p. 408.

23 BANK OF ITALY, *Report for 1976*, p. 349.

even if related to a wide definition of money which includes time deposits and short-term securities. The high interest elasticity of the demand for money depends on the fact that, in Italy, even demand deposits have a positive interest which emphasizes their substitutability with bonds. But this is not *per se* the problem. The irrelevance of a control confined to liquid assets depends on the fact that the money-bonds substitutability is *unstable* in the economic cycle,[24] and hence makes a wider aggregate related to the total financial assets more significant.[25]

In the second place, the increased dependence of firms on external finance [26] accentuates the importance — at least in the short-run — of the volume of credit available to firms rather than that of the amount of money held by the private sector as a whole. Usually greater importance is attributed to the availability of credit than to money in the case of countries whose financial markets are not highly developed and show wide non-price credit rationing.[27] In the case of Italy on the contrary, this would not be attributable to the functioning of the financial institutions, but to the dependence of the corporate sector on external financing. In other words, the credit available would be relevant *per se*, and not only as the necessary mechanism through which money is created. Here again, it is not only bank credit (to which only the creation of money corresponds) which is important, but total credit, which includes all flows of credit reaching firms.

This institutional reality of Italy as interpreted by the Bank of Italy has accentuated those characters in recent years, and that explains the fact that the spread of monetarist theses, while it has been echoed by other Central Banks, has not been accepted by the Bank of Italy.

24 The stability of the function (in the sense of predictability) is more important than its interest elasticity; see E. L. FEIGE - D. K. PEARCE, " The substitutability of Money and Near-Monies: A Survey of Time-Series Evidence ", *Journal of Economic Literature*, June 1977, pp. 439-69.

25 From this point of view, the regulation of the rates paid by the banks on deposits is dangerous: " Only if the rate of interest on deposits is adjusted rapidly to changes in the conditions of the money and credit markets can the potential instability of a huge mass of money be reduced ". BANK OF ITALY, *Report for 1976*, p. 409.

26 According to the analysis of Hicks, the increase in the size of the *overdraft sector* as compared with the *auto-sector*. See J. R. HICKS, *The Crisis in Keynesian Economics*, Oxford, 1974, pp. 50-7.

27 See P. M. KELLER, " Controlling Fluctuations in Credit ", *IMF Staff Papers*, March 1977, pp. 128-53.

In recent years, numerous countries have launched " experiments in practical monetarism " [28], predetermining targets — either single points or ranges — for monetary aggregates. The list of Central Banks engaged in these exercises continues to lengthen. Germany fixes targets for " central bank money "; Canada and Switzerland fix targets for narrowly defined money stock; France and Japan for broadly defined monetary stock. The United States fix targets for three definitions of monetary stock: M_1, M_2, and M_3; while Great Britain has fixed a range for M_3 and a ceiling for domestic credit expansion, according to its agreements with the IMF.[29]

The Italian monetary authorities, on the contrary, remain uncontaminated by this proliferation of targets for monetary aggregates. And we have tried to show that this attitude reflects the situation in Italy, and indeed the problems of the present time.

In the case of Italy, a monetarist strategy is not only *analytically* irrelevant, but also, in recent times, less and less *politically* practicable. And this is because, more generally, the degrees of freedom of monetary policy itself are increasingly more restricted. It would seem, to bring up to date a statement of Baffi in 1971,[30] as regards Italian monetary policy, that, after the *overcaution* of the late forties and the *caution* of the 'fifties and the subsequent *ambition* of the 'sixties, we now have the *impotence* of the 'seventies. This would seem to be due not only to the increased international integration, which makes the external constraints more binding, but even more to the increased domestic constraints caused by the growing size of the public deficit and by the increased degree of indexation of the economy, which tend to determine almost automatically the corresponding financial flows, thus preventing the Central Bank from deciding autonomously the dimension and direction of the financial flows.

In particular, in recent years — see Table I for the comparison between 1966 and 1976 — the Bank of Italy has been faced with a huge increase in the proportion of its total assets represented by credit to the Treasury, in line with the diminution of its net foreign position.

[28] See P. A. VOLCKER, " A Broader Role for Monetary Targets ", *Federal Reserve Bank of New York Quarterly Review*, Spring 1977, p. 26.

[29] The English case is analyzed in my " Fiscal *versus* Monetary Rules ", paper presented at the sixth Money Study Group Conference, Oxford, September 1977.

[30] P. BAFFI, " Ways and Programmes of Monetary Action in Italy: A Glance at Two Decades ", in *Verstehen und Gestalten der Wirtschaft*, J.C.B. Mohr, Tübingen, 1971, p. 243.

BANK OF ITALY AND ITALIAN EXCHANGE OFFICE
CONSOLIDATED BALANCE SHEET
(percentage composition of mid-year figures)

	Assets			Liabilities	
	1966	1976		1966	1976
1. Net foreign position	52.0	−9.4	1. Note circulation	63.0	37.6
2. Treasury	38.0	101.8	2. Banks	29.3	43.7
3. Banks	10.0	7.6	3. Special credit institutions	.8	12.0
			4. Others	6.9	6.7

Source: BANK OF ITALY, *Report for 1976*, p. 242.

The expansion of the public deficit which started off this evolution, together with the preoccupation of the monetary authorities for the control of the rates of interest, has in fact reduced the possibility of the monetary policy intervening. In a situation of this kind, even if it were considered that the control of the money supply was important, the Bank of Italy would be less and less able to exercise it.

6. Conclusions

Even if we do not accept the extreme monetarist theses, it is still true that in recent years both the growth path of total domestic credit and the path of the money supply in Italy have shown marked variations concentrated in time [31] which have certainly not helped to stabilize the economy.

However, a greater stability in the growth of the financial aggregates does not resolve the basic problems. From this point of view, there is no doubt that an optimum solution calls for the identification of an appropriate instrument for each of the three constraints mentioned, and hence international cooperation, and a fiscal and incomes policy. From the coordinated use of these instruments there should emerge a re-equilibrium of the financial structure — with a reduction in the dimension of the financial balances for

[31] In the course of two years, 1975-76, the annual percentage rate of growth of total domestic credit has risen from 16 to 25, but has then gone back to its initial value. See BANK OF ITALY, " Supplemento al Bollettino: Conti Finanziari ", September 1977.

the various sectors — which, on the one hand, will restore *control* and hence *responsibility* to the Central Bank, and, on the other, will avoid financial equilibrium being reached at lower income levels.

In the absence of such a solution, the policy of following " old ideas " in order to put forward old recipes [32] represents a shortcut which will take us nowhere.

Ancona

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32 From this point of view, even the attribution by law to the Central Bank of the objective of price stability, following the German example, does not solve any of the problems of the present time.