

Comment

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In the Nineties inflation has been significantly curtailed. It is now more than halved for the G-7 countries. The long wave of inflation set into motion about thirty years ago is now ended. The substantial price stability we are now enjoying looks as if it will be opening the new millennium. The Nineties have also seen extraordinary acceleration in international financial integration and interaction between increasingly developed markets. A new catch-phrase has been coined – “globalization of financial markets”. So less inflation and more globalization today and, quite probably, in the future too.

These are the two basic points to bear in mind when we now turn our minds to monetary policy and the art of central banking in the year 2000 – when we wonder how the central banks are to behave and what forms monetary policy is to take.

The answer seems obvious. The central banks should take more interest in globalization and less in inflation, not because the latter is in principle of scant importance but because, with stable prices, the financial markets that the central banks have to cope with are and will be for some time concerned less with the risks of inflation and more with the effects of globalization.

But what does this answer mean in practice? In the first place it means no small change in the views that contemporary economic theory takes of central banking. Economists are still used to view the central banks through the lens fashioned by Milton Friedman and monetarism. I have always seen this as a distorting lens. But this opinion, supported only by a mere handful of scholars but by many central bankers – see, for example, the papers in Ciocca (1987), Toniolo (1988) and Nardozzi (1988) – has never found its way into the mainstream of economic thought, engaged as it was in its attack on Keynesian theory, emboldened by the concurrence of two facts that

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history has brought to the fore. The first is the priority attributed to the goal of monetary stability after the unusual inflation wave of the '70s. The second, which grows out from the first, is the importance taken on by a particular approach to central banking, namely the German approach, where the idea that the central bank must with absolute sovereignty handle the sole question of monetary stability finds its fullest expression.

With the EMU project the 'myth' of central bank autonomy propagated by the Germans (Nardozzi 1992) makes further inroads, reaching into our own days and out to the future European Central Bank. It is a myth that has received unprecedented attention from the economists for distant countries of little importance in world economic geography like New Zealand, hailed as valid examples of central banking.

We now have an extensive literature analysing in breadth and depth the empirical evidence on connections between the independence of the central bank, inflation and economic performance (among various contributions to the *BNL Quarterly Review* see the most recent by Jenkins 1996, Prast 1996 and de Haan and Kooi 1997). Even without questioning the – evidently debatable – significance of results pointing to an inverse relation between independence and inflation, this literature is hardly very helpful in analysis of central banking and the problems of monetary policy today and in the coming years. Actually, the very context central banks work in prompts reconsideration of the significance and real importance to be ascribed to their autonomy. It also places the emphasis on discretionary policies rather than on the application of fixed rules, which is complementary to autonomy.

As we know, the question of autonomy arises from the idea that governments tend to generate inflation, bringing pressure to bear on the central banks to finance public deficits with money and/or pursuing expansive monetary policies in support of employment. However, when fiscal policies converge on the aim of eliminating public deficits – as is now the case – the point remains without solid foundations. Moreover, as we have seen in the case of the United States, it is possible to bring full employment to the economy without generating inflation, while no one seems to be thinking of solving Europe's serious employment problem with inflation.

If the grounds are largely removed from the presumption that governments tend to generate public deficits in the hope of financing them with money or think they can only generate employment with inflation, what is the sense in viewing monetary policy from the monetarist viewpoint of central bank autonomy?

In contrast to a tradition of central banking analysis dating back to Thornton, the prescription arising with stress from the myth of autonomy is to limit the bank's discretionary powers by fixing certain targets in terms of money supply and inflation. Public announcement of these targets thus becomes complementary to autonomy and is conceived as holding out an anchor to the financial markets worried by inflation. Once monetary stability has been achieved, however, inflation loses weight in the financial market conventions. When the expected rate of inflation comes within a limited range, between 1.5 and 2.5 per cent – and there is even some doubt that price indexes may exaggerate the figure – there is little need for the anchor. What matters to investors at this point is the central banks' concern with the effects of globalization, with broad fluctuations in exchange rates and in the prices of assets showing even when inflation rates are converging towards stability at low values. The autonomy/fixed rules model is of no help in the analysis of monetary policy when, as in the case of the present Asian crisis, the central banks come up against not inflation but deflation, with financial crisis ominously looming.

If the central banks are to take more interest in globalization and less in inflation, then the old idea held by Thornton and Sayers that discretionary powers are essential for central banking – and that autonomy is to serve this end, not to condition monetary policy – is in for reappraisal.

Confirmation on this point comes from the work by Alvaro Almeida and Charles Goodhart presented here. The authors' final verdict on the question "Does the adoption of inflation targets affect central bank behaviour?" is "unproven" (cf. Almeida and Goodhart, p. 100). There is no evidence that inflation targeting (IT) has made any significant change in central bank behaviour. It has had no discernible impact on the credibility of the banks adopting it. The good results obtained in terms of curbing inflation do not stand out from those obtained by the majority of the central banks not adopting IT. Moreover, the targets are often missed, which prompts a widening of the target range to avoid losing credibility instead of gaining it. There do not therefore appear to be any great differences in behaviour and

performance between IT and monetary targeting. Moreover, as Lamfalussy points out, monetary targeting cannot be pursued rigidly since, in a globalized world, the money supply target is hard to control and fails to show even reasonably stable relations with prices. It is also difficult for central banks to calibrate monetary policy on consumer-price stability alone. With globalization there is a greater chance of speculative bubbles in asset prices as financial impulses come in from abroad, with consequent effects on inflationary expectations and risks of financial instability, which the banks themselves must check.

Thus adopting targets – whether of inflation or money supply – does not mean there is no more need for discretionary faculties, which in fact come very much into play with the flexibility needed to deal with a situation of low inflation and globalization. Adopted in the past in acknowledgement of the monetarist model as tools to prevent the central banks from dealing with anything other than monetary stability, these rules now seem to serve primarily as tools for communication with the public. They become means to make central bank behaviour transparent and accountable, as emerges clearly from the contributions by Almeida and Goodhart, and Lamfalussy, and thus to justify to the public the discretionary faculties that remain more than ever an essential feature of central banking.

These are, I feel, important points for the debate now in progress on how the rules to be adopted by the future European Central Bank are to be conceived. This is rather more interesting than the cases considered in the Almeida and Goodhart research since it concerns an institution being created on a particular national bank model, grounded on the specific features of German capitalism, although it is to operate in an entirely new scenario, the economic and financial area of the euro. It is an area that will contain a capital market aiming at competing with its American counterpart. The European Central Bank will have to get to grips with globalization and the responsibility to maintain financial stability, with a far wider-reaching international role than the Bundesbank. And it is, above all, this new institution that will be called upon to concern itself more with globalization and less with inflation, showing the intelligence to set its sights beyond the anti-inflationary credibility that has already entered its heritage.

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