

# Comment

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The Asian crisis and its domino effect have brought to the fore certain consequences of the globalization of markets, shifting the focus sharply from the contribution finance normally affords the economy in terms of efficient allocation of resources and growth to some of the more dramatic and negative aspects.

How did these interconnections spread out to the worldwide scale? Lamfalussy seeks to answer such questions in his paper.

Deregulation of the financial markets, free movement of capital round the world, information technology and innovations in the financial field are the four major macrophenomena accounting for the globalization of the financial markets. I myself had occasion to illustrate these causes at a Lincei Academy conference last April, but the point I wish to stress now is the extraordinary growth of financial derivatives. According to BIS figures, over the counter derivatives for all types of contracts amounted to about 41 thousand billion dollars net of duplication in 1995. Indeed, some commentators place derivatives among the essential nerve-centres for the propagation of the worst financial crises occurring over the last decade.

Such phenomena not only fuzz the dividing lines between the various types of financial intermediaries but, in virtue of the increased liquidity accruing to the various financial tools, also blur distinction between monetary – in the strict sense of the word – and other activities.

Thus we also find changes in the channels for the transmission of monetary policy, the credit channel narrowing as the exchange channel swells. Above all, there would seem to be sweeping changes in the traditional channel based on fixing intermediate objectives in terms of monetary aggregates.

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□ LUISS-Guido Carli, Roma (Italy).

Some doubt that it is still feasible to pursue monetary policy along such lines: intermediate objectives can no longer be so readily verified by the central banks, while relations between intermediate and final objectives are by no means as stable as they used to be.

It little matters whether this instability does in fact reflect Goodhart's Law, which states (in accord with Lucas' critique of econometric models) that any statistical uniformity will be invalidated whenever it comes under pressure through verification of final objectives, or whether it depends on exogenous factors and the rapid adjustment of operators' portfolios afforded by a whole range of innovations.

The fact remains that the monetary authorities are faced with a control panel that is steadily falling apart. Some argue that the next step should be towards inflation targeting, and Lamfalussy holds that – over and above the textbook distinctions – this would be no great revolution.

In the face of such an authoritative opinion the German monetary authorities, in a last ditch defence of what Issing defines as monetary pragmatism, deny that Goodhart's Law can apply to Germany, maintaining that relations between monetary aggregates and prices remain valid in the medium period.

True, the Bundesbank recognizes that in the short term the monetary aggregate chosen as intermediate objective (M3) can undergo considerable fluctuation (see the Bundesbank *Bulletin* of August 1996) through international shock effects or sudden changes in expectations. This, however, does not necessarily undermine medium-term relations between M3 and price stability and therefore, they go on to argue, would not call for short-period adjustment of monetary policy.

In his paper Lamfalussy comes down on the side of those monetary authorities who go on regardless, defining paths for monetary aggregates to move along as medium-period objectives. Their quantitative pronouncements act as signals revealing stance in monetary policy, and are readily interpreted by operators as such. However, they should be backed up by commitment from the central bank to account for its behaviour *ex post* (in the appropriate forums), or in other words to explain why it has or has not introduced corrective measures when monetary aggregates depart from the intermediate objectives previously decided upon. Compulsory disclosure would have a restraining effect should the bank be tempted to use discretionary

powers and would confirm indications of a quantitative objective, even though the exact dimension of the money supply and the role it played in inflationary processes could not be determined.

It is as well to remember that in the traditional rules-versus-discretionary powers confrontation the monetarists held the quantity of money perfectly controllable, asserting the superiority of a fixed rule for money growth over discretionary intervention. Adjustments in intermediate objectives were only to be made when significant departures of the final objectives from the pre-defined values did not depend solely on transient factors and time lag. Today the rules-discretionary powers confrontation is not so clear-cut, and the decision not to make adjustments rests on other grounds. Medium-term strategy is no longer accounted for solely with the need to provide operators with certainties, avoiding the destabilizing effects that swings in monetary policies have on expectations, but also with the conviction that a certain stability in relations between intermediate and final objectives (i.e. between growth in M3 and stability in the rate of inflation) can only be achieved in the medium period, while there could be no controllable aggregate or stable relations in the short period.

Here the doubt arises that a good econometrician might, with the right periodization and selection of data, almost always demonstrate a certain stability in the relationship in the medium period.

A further complication (as Greenspan pointed out in a recent address at Stanford) is that it is now becoming increasingly difficult to measure the rate of inflation on account of qualitative variations in the commodities, technical progress and frequent variations in the housewife's shopping basket, while there are also at least two price indexes to consider – not only for goods and services but also for financial assets. The latter index is the most affected by globalization of the markets and can be distorted by speculative bubbles altering its significance as an indicator.

In such cases, in addition to bulwarking money value stability, monetary policy also has the task of drawing the markets towards more realistic evaluations.

As Lamfalussy points out, when the consumer price index remains practically stable while financial markets are enjoying a real boom, one cannot help wondering whether monetary policy is too permissive. It is by no means easy to anticipate the future impact of

variations in financial and real estate assets trends on the prices of goods and services, especially if the speculative bubbles are swollen with financial flows blowing in from abroad, but there can be significant consequences for the real economy. Suffice it to recall the earlier stock market crash in 1987, the response of real estate to shrinking speculative bubbles in Japan, in recent days the Asian crisis, producing effects that we cannot as yet size up.

If both consumer price and financial business indexes move in the same direction a clear line for monetary policy can be discerned and implemented, whether based on intermediate monetary aggregate objectives or on operating targets such as the nominal short-term interest rate, as is the case in the USA today. If no clear line can be seen, then each step must be clearly accounted for. Given the power of expectations, the view expressed by a central bank on financial market trends (once considered an absolutely unorthodox thing to do) may exert even more weight than an actual economic policy intervention. Hence the doubt that transition from real to financialized economy may leave room for a quasi-virtual monetary policy given the speed of data processing and the sensitivity of market response.

Explanation of why adjustments are or are not made when deviations from monetary policy targets occur enhances the accountability of the central banks. However, the world financial markets also exert a further form of control; the influence market opinion has in judging monetary policy has grown enormously since globalization. Moreover, this form of control extends to the entire economic policy of the single countries. On the particular question of how monetary policy is judged, reactions of the markets may contrast it quite sharply.

If it is not only monetary policy but also the economic policy as a whole that count for stable, sustainable growth over the medium period, we may well understand the reactions shown by the markets, which can turn distinctly unfavourable even when monetary policy shows all due rigour. They may, for example, pinpoint inconsistencies and errors in economic policy that will eventually release their disruptive potential, but they may also throw exchange rates out of their basic alignment, and the huge flows thus generated make corrective measures extremely arduous. The fact that financial investment decisions are increasingly becoming the domain of a few big institutional

investors moving in the same direction, losing no time in rapid revision of their choices, also means increasingly volatile markets and greater uncertainty and risks in investment decisions at the microeconomic level.

Information technologies have enhanced the sovereignty of the markets and extended their frontiers. Naturally, if we are thinking of giving marks we may look into the procedures: are the rules truly rational, are any essential points in evaluation being neglected, and do they in fact meet the needs of the economy in terms of stability and growth? Judging market behaviour is a complicated business, and no final judgement seems to be forthcoming. Economists and operators agree on the need for credible economic policy that can stand up to the abrupt swings shown by quotations of stocks and exchange rates – swings that can trigger off negative repercussions for the real economy. The central banks are rallying their forces, not only keeping an increasingly watchful eye on developments but also co-ordinating their action. The will is there to lay down rules. However, there can be no going back to the past; we cannot afford to ignore market reactions and side-step the challenge. The opportunities are there to be exploited, and they amply surpass the costs and problems involved in moving on to the future.