

# MONETARY POLICY EFFECTIVENESS AND CENTRAL BANK AUTONOMY: LESSONS FROM THE ITALIAN MONETARY POLICY REGIME CHANGE OF THE EIGHTIES

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## 1 INTRODUCTION<sup>1</sup>

The 1980s were, for the Italian economy, years of disinflation, after a long period of marked price instability (*Chart 1*). Abating inflation was a success of economic policy, particularly of monetary policy. The central questions posed by this presentation is: was such a success only the result of a shift in the policy stance, or did a true change in monetary regime occur? If the latter is the case, which were the key features of such a change?

From the 1970s to the 1980s monetary policy in Italy turned increasingly restrictive, following similar patterns prevailing in most developed countries. In the 1970s most advanced countries were plagued by high rates of inflation. As early as 1974 the Bundesbank had begun to announce objectives for the money supply, with the explicit aim of rapidly curbing inflation. Then came the shift in US monetary policy: in 1979 Paul Volcker, who had just replaced Arthur Burns as Chairman of the Board of Governors of the Federal Reserve System, began to revolutionise the conduct of monetary policy with a rapid increase in interest rates and, above all, with the explicit objective of curbing inflation. This was a radical change in approach. Before Volcker, central bankers, and not only in the United States, had seen inflation as a sort of unavoidable evil rooted

in the economy and in expectations, as argued in a famous essay by Burns (1987).

A distinctive tightening also occurred in Italian monetary policy, with a first increase in the discount rate in October 1979, followed by others in the subsequent years. The total increase by March 1981 amounted to 8.5 percentage points and took the discount rate to 19%, its highest ever level. The magnitude of such a shift in policy stance can be appreciated looking at two very standard indicators, the short term real rate of interest (*chart 2*) and the rate of growth of money (M2) supply (*chart 3*).

In comparison with other countries also engaged in the fight against inflation, peculiar to Italy was the socio-political context, less favourable than elsewhere to the adoption of disinflation policies. Public opinion and the political class were less convinced of the undesirability of inflation. Above all, the institutional and structural obstacles to the central bank pursuing its objective effectively and at a reasonable cost were especially serious.

In what follows we will argue that a true change in the monetary regime took place in Italy in those years, and that it was prompted by fundamental modifications occurred in the final objective of monetary policy, instruments and strategy, *modus operandi*.

In addition, two “accompanying factors” proved to be essential: 1) the evolution in the theoretical approach; 2) the evolution in the institutional set-up. In the next chapter we will first examine these two factors.

## 2 EVOLUTION IN THE THEORETICAL APPROACH

Economic thought on monetary policy and the role of a central bank has made a long road from the 1960s.

Forty years ago the prevailing theory among macroeconomists was very different from the one now prevailing. Supposedly Keynesian-inspired models, based on the hypothesis of the long-term validity of

the Phillips curve (a constant, inverse correlation between inflation and unemployment), showed that one could use expansive monetary policy to “buy” a permanent reduction in unemployment, for a limited and temporary cost in terms of inflation. For two decades or more economic policy in the leading countries was powerfully influenced by these ideas. One of the consequences was a firm belief that central banks needed to be subordinated to government, the sole institution that could legitimately select the socially optimal combination of unemployment and inflation.

Economists such as Friedman and Phelps criticised this approach, arguing that in the presence of expansionary monetary policy, expectations fuel inflation, altering its relation to unemployment in such a way as to make the employment gain ephemeral and the inflation cost permanent. This criticism began to be incorporated in theory and econometric models in the early 1970s, but for all of that decade it did not dampen the enthusiasm of those who advocated directing monetary policy chiefly to the objective of full employment of resources.

Economic thought did not really begin to change until the great shocks of those years (the collapse of the international monetary system based on the dollar standard, the energy crisis of 1973) had touched off an inflationary firestorm that redirected the public’s attention to the damage and danger of inflation, which had been virtually forgotten. This revived the debate on the nature and institutional status of central banks.

In the last quarter-century monetary policy theory has “rediscovered” the concept of independence of central banks, owing to the great impression made by the inflation of the 1970s and apparent differences in the leading countries’ ability to combat it. A peculiar current of economic literature sprang up, forming part of the broader theoretical school of “new classical macroeconomics” associated with Robert Lucas and Thomas Sargent. This current began with the elaboration of the concept of “time consistency” of economic policy<sup>2</sup>, according to which, for a policy to be credible in the eyes of private agents with rational expectations, it must be consistent over time. When the policymaker acts discretionally, optimal policies are

not time consistent and will have to be abandoned, however excellent they may be in theory. Consequently, an “institutional straitjacket” is useful in forcing policy-makers to implement optimal policies observing time consistency.

A few years later, these reflections were applied to monetary theory.<sup>3</sup> In equilibrium, it was held, a monetary stance expansionary enough to push unemployment below its natural level will not go unnoticed by those who set prices (producers and wage-earners); in the end it will prove ineffective, not to mention costly in terms of higher inflation. It was argued that the problem could be resolved at the root by permanently delegating the design and implementation of monetary policy to an independent central bank that is more inflation-averse than the average government.<sup>4</sup>

This current thus makes central bank independence in pursuing long-term price stability the solution to an abstract problem of searching for the greatest possible social welfare. This line of research exerted a profound influence on the reform or initial design of a number of old and new monetary institutions, first and foremost the European System of Central Banks, which has set common monetary policy in the euro area since 1999.

In the Bank of Italy, at varying levels of operational responsibility, the evolution in the economic thought on the issue of monetary policy strategy and the role of the central bank was monitored and discussed. To assess the intellectual itinerary which was followed, let us compare two quotes, referring to the final objective of monetary policy, taken from public speeches by the incumbent Governor of the Bank in two moments distant 17 years from each other:

*(the Bank of Italy's primary concern is) ... “to promote a level of income that ... would permit a level of investment capable of closing the gap between Italy and other members of the EEC”. ... “account should also be taken of the objective of ... maintaining the equilibrium between domestic and international prices”.* (G. Carli, 1967)

*“The forms of monetary control being discussed are basically directed towards price stability and the macroeconomic equilibrium of the system”.* (A. Fazio, 1984)

The contrast between these two statements could not be starker: in the 1960s the chief policy concern was capital formation, while in the early 1980s the final objective of monetary policy was explicitly set first and foremost in terms of price stability.

### 3 EVOLUTION IN THE INSTITUTIONAL SET-UP

These reflections regarding the final objective were only translated gradually into the daily practice of Italian monetary policy.

During the 1970s monetary policy was impaired by the rigidities in wage and price setting, the restrictions on the central bank's autonomy in using its instruments, and a public expenditure that was expanding rapidly.

From an operational point of view, at the end of the 1970s, although it enjoyed a high degree of *de facto* independence from the political sphere, the Bank of Italy was still facing serious limits in its ability to control the money supply and short-term interest rates. The main reason for this was the requirement by law to finance the Treasury's (large) deficits automatically through the issue of monetary base. From 1975 onwards, under a resolution adopted by the Interministerial Committee for Credit and Savings, the automatism was reinforced, imposing to the Bank the obligation of purchasing all the government securities that were not taken up in auctions. In addition, the power to change the discount rate was formally entrusted to the Treasury, which acted on a mere proposal from the Bank of Italy.<sup>5</sup>

The idea of severing the operational link between the Bank and the Treasury, thus stating the formal independence of the former from the Government and from political parties, came to the fore in 1981, with the decision taken by the Bank to "divorce" from the (by then consenting) Treasury in the placement of government securities, putting an end to the unnatural "marriage" contracted in 1975<sup>6</sup>.

At the technical level the effects of the divorce emerged gradually. It nonetheless greatly enhanced the autonomy of the central bank

and was essential for a management of interest rates consistent with the objective of disinflation.

Another important institutional change marked the evolution towards what I am calling a regime change in monetary policy: Italy's participation in the European Monetary System (EMS) from its inception in March 1979.

In fact, the constraint inherent in compliance with the exchange rate obligations of the EMS came to be used to pursue the objective of disinflation, both strategically and tactically. The exchange rate constraint could be accepted by the political sphere and by the public, and it impinged directly on firms' costs and competitiveness, thus influencing economic agents' expectations and behaviour in setting prices and wages.

In the 1970s Italian industrial firms had had to grapple with enormous increases in production costs, owing to the rise in the cost of energy and raw materials and, above all, to the wage increases that the growing strength of the unions imposed. The increases in costs had been larger than those incurred by their main international competitors. They risked being excluded from some important markets and losing considerable ground in the domestic market. Repeated devaluation of the lira had come to their rescue, not just offsetting the cost differentials vis-à-vis their competitors but giving them considerable margins of competitive advantage. The real devaluation of the lira in the 1970s,<sup>7</sup> i.e. that in excess of what was needed simply to offset the cost differentials vis-à-vis Italy's main trading partners, amounted to more than 20%.<sup>8</sup> From the inception of the EMS (spring 1979) to the end of 1990 there was a roughly equal real revaluation of the lira (*Chart 4*). As it will be discussed later, this performance reflected the adoption of a disinflationary stance in Italian monetary policy.

#### 4 A NEW STRATEGY IN MONETARY POLICY

To sum up, the main problem for the Bank of Italy at the beginning of the 1980s was to curb economic agents' inflationary expectations.

In order to do that, the Bank needed to make a more active and autonomous use of its monetary instruments.

The solutions envisaged were: 1) to exploit the EMS constraint; 2) to exploit the “divorce” in order to shift from direct control of credit to indirect control of monetary aggregates through the management of short-term interest rate. The two actions amounted to a true change in monetary regime.

Let us first discuss the EMS issue. The rules of the EMS did not allow a country to devalue its currency whenever it chose;<sup>9</sup> when a currency came close to the lower limit of its fluctuation band against one or more currencies, the central bank was required to become a residual buyer in the market, so as to keep its value within the band.<sup>10</sup> Where defence of the central parities proved to be manifestly contrary to the underlying trends of the economies involved, there was provision for a realignment, to be decided in multilateral consultations among all the EMS countries. During the 13 years of the effective lifetime of the EMS,<sup>11</sup> central parities were realigned on numerous occasions, most frequently in the early years. The lira was nearly always involved, devaluing with respect to all or most of the other currencies. After most realignments the lira initially held its ground (*Chart 5*), with a consequent rise in the real exchange rate owing to the persistence of labour cost differentials. As tensions on the foreign exchange market grew more severe, the lira was left to slide gradually, to a point where it became necessary to provide room for manoeuvre again. At such times Italy applied to its partners for a realignment of the lira’s central parities or joined in a more general realignment requested by other countries.

All in all, during the 1980s the exchange rate of the lira went through periods of real revaluation and devaluation, separated by realignments of its EMS central parities. In the periods of real revaluation the exchange rate exerted the maximum pressure in countering the rise in domestic prices, like a wound-up spring; in the periods of real devaluation the Bank of Italy adopted an easier monetary policy stance, allowing the real exchange rate of the lira to fall (and the spring to unwind). As one period followed the other, the exchange rate spring was never left to unwind completely; in

the periods of monetary easing the permitted real devaluation was progressively reduced.

As to the effects of the “divorce” on the use of monetary instruments by the Bank of Italy, clear evidence of a true new regime emerged at the end of 1982. In the autumn the Treasury’s financial situation deteriorated: the rapidly growing borrowing requirement made market financing increasingly difficult and led to upward pressure on interest rates. However, the Treasury did not reduce base prices in its auctions, as suggested by the Bank of Italy. By contrast, the Bank increased the interest rates on its own operations to curb the expansionary effect of the borrowing requirement fixed by the Treasury in auctions. The demand for government securities in the primary market fell. At the end of the year the Treasury exhausted the line of credit on its current account with the Bank of Italy; the Bank refused to buy government securities. The Government was forced to obtain Parliament’s approval for an extraordinary advance from the central bank.

Since then the Bank of Italy gave increasing consideration to intermediate objectives expressed in terms of the money supply, which were publicly announced from 1984 onwards. A gradual reduction in nominal interest rates paralleled the slowing of inflation, interrupted from time to time, in response to monetary or foreign exchange indicators. The steady abandonment of administrative controls on credit and the financial market reforms enacted between the middle of the 1980s and the early 1990s created the conditions for the effective use of the indirect instruments of monetary policy.

## 6 CONCLUSIONS

In 1987 Governor Carlo A. Ciampi wrote:

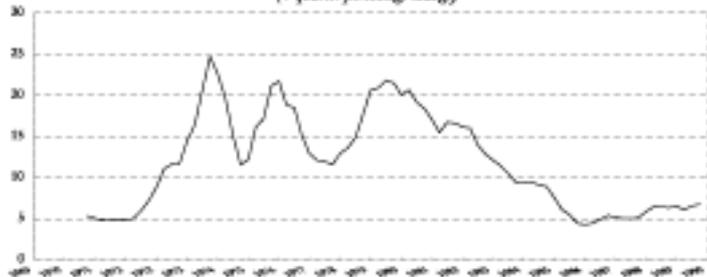
(in the early 1980s in Italy) ... “many doubted that (inflation) could be curbed, and were even more sceptical that could be done without stifling the nation’s industry ... The spectre of de-industrialisation did not materialise.” (Ciampi, 1987)

The reduction in inflation in the 1980s was substantial; however, it was achieved only gradually. The introduction of a new monetary regime (or “monetary constitution”, as Governor Ciampi called it) was also a gradual process and did not produce its full effects until the following decade.

Not all the possible channels by which the new, non-accommodating, monetary policy regime could counter inflation were equally effective. The direct impact on firms’ behaviour in setting prices and negotiating wages was extremely effective, stemming from the effect of the exchange rate on costs and on competitive pressure and from the reversal of the perception among social partners that the central bank’s policy would be time-inconsistent. The transformation of the institutional context in which monetary policy operated was much slower, although the changes made were of major importance in the longer term; the shift in monetary policy was followed only very gradually by the changes to the monetary constitution advocated by Governor Ciampi (full autonomy in the use of the central bank’s instruments and better procedures for public expenditure decisions and for wage bargaining). In this sense monetary policy undoubtedly made the first move.

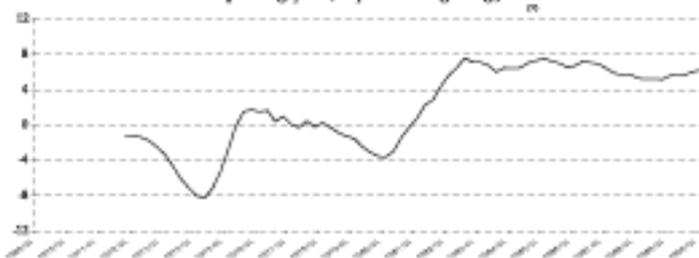
The very gradualness with which the way of conceiving and conducting monetary policy succeeded in overcoming Italian society’s acceptance of inflation suggests that the causal link runs from the change of monetary strategy to inflation stabilisation, rather than the other way round. Exploitation of the exchange rate constraint and the recovery of autonomy in the management of the monetary base were the two main aspects of the shift. The first, thanks in part to the symbolic value it had for politicians, employers and the unions as the necessary condition for participation in European integration, allowed the Bank of Italy to pursue its disinflation objective; the second allowed it to actively use the instruments of monetary policy, which was essential to ensure that the formal adoption of the exchange rate constraint, potentially an “empty ambition”, resulted in an effective stabilisation policy.

Graph 1: Consumer price inflation  
(4-quarter percentage change)



Source: Istat

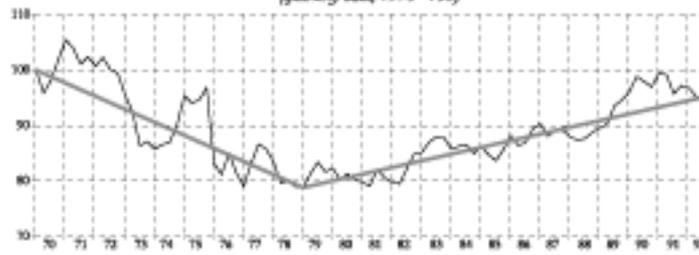
Graph 2: Real short-term interest rate  
(percentage points, 4-quarter moving average)



Source: Bank of Italy and Foras-ME survey

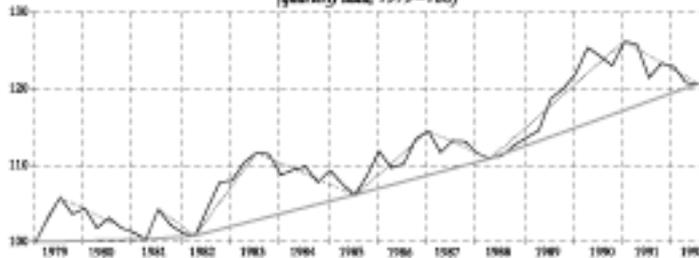
(1) Interest rate on interbank sight deposits adjusted for expected consumer price inflation in the next quarter.

Graph 3: Real effective exchange rate of the lira based on unit labour costs  
(quarterly data; 1970=100)



Source: Bank of Italy

Graph 4: Real effective exchange rate of the lira based on unit labour costs  
(quarterly data; 1979=100)



Source: Bank of Italy

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## ENDNOTES

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<sup>1</sup> This presentation is based on a longer article written with Eugenio Gaiotti (Banca d'Italia Research Department). See in the References: Gaiotti, Rossi (2004).

<sup>2</sup> Introduced by the pioneering essay of Kydland and Prescott (1977).

<sup>3</sup> Barro and Gordon (1983).

<sup>4</sup> Rogoff (1985).

<sup>5</sup> The power to change the discount rate was formally assigned to the Governor of the Bank of Italy in February 1992.

<sup>6</sup> The “divorce” was not the outcome of an extensive political debate but the result of an agreement between economist Beniamino Andreatta, who had become Treasury Minister, and Governor Carlo A. Ciampi. The divorce was enacted in the technical form of an exchange of letters between the Treasury and the Bank without the formal approval of the Interministerial Committee for Credit and Savings.

<sup>7</sup> Measured on the basis of the changes in the “effective” (i.e. weighted average) exchange rate with respect to the currencies of Italy’s main trading partners.

<sup>8</sup> On the basis of quarterly data, from the first quarter of 1970 to the first quarter of 1979.

<sup>9</sup> The market exchange rate could fluctuate around the “central parity” fixed for each pair of currencies participating in the system within a band set equal to  $\pm 2.25\%$  for every currency except the lira, which had been granted a band equal to  $\pm 6\%$  in view of its inherent weakness.

<sup>10</sup> To this end, the central bank could count on the availability of very short term credit lines at the central bank(s) at the other extreme of the band for theoretically unlimited amounts.

<sup>11</sup> The EMS remained fully in operation from March 1979 to September 1992, when the pound sterling and the lira dropped out. In the summer of 1993 the fluctuation margins of all the participating currencies were widened to  $\pm 16\%$ , which deprived the EMS of any practical significance and reduced it to nothing but a simulacrum pending the arrival of the euro.