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# Quale politica monetaria? Il dibattito sul monetarismo (Which Monetary Policy? The Debate on Monetarism)

Book Review by GIUSEPPE TULLIO

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CREA's initiative in publishing a collection of five essays, by authoritative scholars, on the role of monetary policy in some Western countries in the early 1980s is undoubtedly praiseworthy. Of the five essays, the first two, i.e. « Monetarism? » by Antonio Martino and « What should have been expected from monetarism? » by David Laidler, are introductory. The third, by Milton Friedman, deals with monetary policy in the United States from 1979 to 1983 and the fourth, by Michael Parkin, with monetary policy in Great Britain in the same period. Their objective is to determine the extent to which these two countries effectively followed Friedman's two prescriptions in relation to monetary policy. These two prescriptions are: first, the adoption of a monetary aggregate as a primary objective of monetary policy and, secondly, the willingness to use monetary policy tools to produce a steady and foreseeable growth rate in the chosen monetary aggregate. The fifth essay, by Rainer Masera, analyses monetary policy in Italy in the period 1970-1983 and differs from the preceding two essays not only in that Masera covers a much longer period but particularly in that he adopts a different theoretical perspective in his analysis.

While the two preceding essays start from the assumption that the monetary authorities should follow Friedman's prescriptions, Masera explains, in the introduction to his article, that the control of money is difficult, if not impossible, in a situation where public sector deficits are high, where there are variable interest rates paid on a part of monetary assets and where there is rapid financial innovation. These factors, in fact, make the demand for money unstable. As can easily be inferred, the difference in theoretical perspective is not of just academic significance. The Central Bank which follows, or which is compelled by the government (or by the Constitution) to follow Friedman's prescriptions, is a technical organ with limited discretionary powers. The Central Bank that emerges from Masera's conceptualisation has a lot more discretion and can pursue multiple objectives whose importance can vary over time, as the emphasis varies from the fight against inflation to the balance of payments, to the financing of the Treasury deficit at stable interest rates and to supporting a recovery in investments.

One question must be asked and that is, which of the two perspectives is best, the « monetarist » of Friedman and Parkin or the « eclectic » of Masera? The book does not answer this question and, indeed, I do not think that an unequivocal answer can be given to it. I shall limit myself to some personal observations. First of all, the comments made by Masera in his introduction are, to some extent correct: high and variable

public sector deficits do make it more difficult to adhere to monetary objectives consistent with « low inflation », and the demand for money is less predictable where there are financial innovations and, I should add, high international substitution among currencies. Nevertheless, an important policy induced cause of the instability of the demand for money in Italy in the 1970s was, in my opinion, the restrictions and controls on credit which were, later, abandoned but reintroduced in January 1986. This important cause of the instability of the demand for money in Italy is not mentioned in Masera's paper. Another factor which makes it difficult to adopt a monetary objective is, according to Masera, the variability in the multiplier of the monetary base, due to the influence of interest rates on the currency-deposit and the reserve-deposit ratios. I do not think that this is a major problem, however, because, as Parkin suggests for Great Britain and as is already the case in Germany, the Central Bank can directly fix an objective in terms of the overall monetary base or a related concept. The latter is also less affected than are other monetary aggregates by financial innovation and its demand function is, therefore, probably more stable [1]. For this reason, I think, despite the objections raised by Masera, that the Central Bank should, at least, set an objective in terms of the overall monetary base, without necessarily announcing this to the public. This objective should be pursued with a certain rigour and should be changed, at the Bank's discretion, only in « serious » cases. These serious cases could be, for example, substantial financial innovations which also affect the demand of the monetary base and situations which threaten the stability of the banking system. As far as the Central Bank of the United States is concerned, a « serious case » could be the danger of world recession linked to the insolvency of developing countries [2]. I would not include the approaching of political elections, support for a recovery in inventories and investment or unplanned increases in the public sector deficit as « serious cases ». A monetary policy set in this way implies, of course, greater flexibility in interest rates.

If we analyse the monetary policy followed by the Bank of Italy from the « divorce » of July 1981 to the present from this perspective, it seems to me that, apart from the acceleration that occurred in the first six months of 1985 which was then, partly, reversed, excessive oscillations in the monetary base have been avoided. From 1970 to the divorce, by contrast, the Italian monetary base underwent enormous oscillations, particularly from 1972 to 1973 (from 10% to 21%) and from 1974 to 1975 (from 13.2% to 44.3%). Oscillations in the monetary base of the Treasury were even more pronounced. From 1972 to 1973 it increased from 19.4% to 52.5% and from 1979 to 1980 from 0.8% to 24%.

[1] Despite the factors mentioned above, empirical evidence shows that the demand for money in Italy is quite stable. See S. CALLIARI - F. SPINELLI - G. VERGA, «The Demand for Money in Italy, Further Results» in F. SPINELLI - G. TULLIO (eds.), *Monetary Policy, Fiscal Policy and Economic Activity: The Italian Experience*, Gower Publishing Company, Aldershot, 1983.

[2] It is possible that in the second half of 1982 the risk of insolvency of developing countries was one reason why the Federal Reserve relaxed the reins on its monetary policy.



The change in orientation in Italian monetary policy after the divorce should, in my opinion, be considered in a very positive light. That change shows that, at least in the Italian context, high public sector deficits do not necessarily constitute an insurmountable obstacle to a certain stability in the growth of the monetary base since these deficits were, on average, considerably higher in the post-divorce period.

To go back to the original question of whether the monetary perspective of Friedman and Parkin is, in my opinion, better than the eclecticism proposed by Masera, it seems to me, paradoxically, that when the Central Bank becomes aware of the importance of the monetary base and of money in the process of inflation and when it maintains the rates of increase of the monetary base at a relatively stable level, it does not need either to adhere rigidly to objectives previously set by the government or to announce a monetary aggregate to the public. Vice versa, I should maintain that, given the experience of the 1970s, Italy would have benefitted from a lower average rate of inflation, from less persistent crises in the balance of payments and from greater stability in the growth of incomes and employment if there had been a legal or constitutional obligation to adhere to an intermediate objective defined in terms of the Treasury component of the monetary base or of the overall monetary base [3]. It is true, as Masera maintains that, in the context of an exogenous shock, like that of the oil crisis, and of increases in real salaries and high levels of public sector deficits some overshooting of the monetary base with respect to previously set objectives did facilitate the reduction, in the short term, of the costs of real adjustment of the system. I feel, for example, that the monetary policy of Germany, after the first oil crisis, was too unaccomodating. But it seems to me that there are some intermediary and better solutions between the extremes of continuing with one's monetary policy almost unchanged after an unexpected exogenous shock like that of the oil crisis of 1973/74, and the type of relaxation of monetary control which the Italian authorities allowed in the 1970s. Furthermore, if the necessary legal and constitutional obligation had existed, the economic pressure on the Treasury and on the government to reduce the high public sector deficits would have started years before [4].

It is interesting to pose the question whether the Bank of Italy would have been technically capable in the absence of a divorce between the Treasury and the Bank of Italy of keeping the overall monetary base in the course of the 1970s, along a more stable trajectory than that which it actually achieved. Masera seems to think not when he writes « In fact, the capacity to control was limited, up to the so-called divorce of 1981, by the Bank's obligation to purchase, residually, the Treasury bills which were not allocated when they were issued ». I agree that, in the very

[3] Figures 5 and 6 of Masera's paper show the wide oscillations that actually occurred in real interest rates in the 1970s. It is plausible to maintain that, in the absence of these, fluctuations in the balance of payments and in aggregate demand would have been less pronounced.

[4] This is also the opinion which Mario Monti has expressed in various articles in *Corriere della Sera*.

short term, the obligation to buy up all the Treasury bills that were not sold when they were issued made the control of the monetary base more difficult but over a three month period and, even more so, over a year, a Central Bank can, even when it must fulfill this type of obligation, avoid wide oscillations in the monetary base by raising the interest rates so as to ensure that no bonds from later issues will remain unallocated. Furthermore the Central Bank can operate on the open market to compensate for its excessive purchases of Treasury bills at the time of issue.

Before going on to the monetary policies of the United States and the United Kingdom, as analysed by Friedman and Parkin, respectively, I should like to conclude my comments on Masera's work with an observation on the usefulness of total domestic credit as an intermediate objective of monetary policy and one on the monetary policy changes of January 1986. Total domestic credit is, at the moment, at least officially, the principal intermediate objective of Italian monetary policy. Masera maintains that it is « not an objective of monetary policy alone » (page 142). Total domestic credit is, in fact, the result of actions of monetary policy but it is also, in large measure, the result of the behaviour of public sector deficits. It seems to me that, if we are to have a proper division of responsibilities between the authorities responsible for monetary policy and those responsible for fiscal policy, the monetary authorities should not adopt an objective like total domestic credit. The same criticism does not apply to the same extent at all to the monetary base. Moreover, it has not only been put forward theoretically but shown empirically that total domestic credit has a much more unstable relationship than the monetary base and money with the principal final objective of monetary policy, nominal income [5]. This intermediate objective should therefore be abandoned.

In January 1986 the Italian monetary authorities reintroduced credit controls which had been abandoned at the beginning of 1983 and reversed their earlier policy of relaxing controls on international capital flows. As the experiences of the United Kingdom and Denmark show, if domestic economic policies and especially monetary policies are sound, capital controls can be discountinued without negative consequences for the country's international reserves. Capital controls serve no useful economic purpose any longer in Italy. At the same time they are costly to administer, and interfere with the optimal international allocation of savings and economic resources. They retard financial innovation in Italy and make it harder for Italian financial institutions to compete for their share of the world financial markets. Furthermore the Italian government's stance on capital controls is in my opinion in open contradiction with its stance on the Ecu and on European monetary integration.

The principal conclusion of the two essays by Laidler and Parkin is that, since 1979, neither the United States nor Great Britain have

[5] A. PENATI - G. TULLIO, «Total Domestic Credit as an Intermediate Objective of Monetary Policy in Italy» in F. SPINELLI - G. TULLIO (eds.), *Monetary Policy, Fiscal Policy and Economic Activity: The Italian Experience*, Gower Publishing Company, Aldershot, 1983.



followed a monetary policy « of stable growth » of the monetary aggregates since these have fluctuated a great deal over the period. It follows from this that the American and English experiments cannot be considered a direct test of « monetarist » policies. It is difficult to disagree with Friedman and Parkin on this point. The factors that contributed to the increase in instability in the growth of monetary aggregates in the United States are, according to Friedman, direct controls on credit, the fact that, for most of the period, the obligatory reserves of the banks were calculated on the basis of the deposits lagged by two weeks and the continued emphasis on the short term stabilisation of the nominal interest rates. For Great Britain, Parkin maintains that the principal reason was the fact that the Bank of England was not convinced of the efficacy of « monetarist policies » and pursued, therefore, objectives other than the stabilisation of the growth of the monetary base or of money.

I have four observations to make on the essay by Friedman. First, the constraint that the growing federal deficits imposed on the implementation of monetary policy and the effect that these had on the real rates of interest, particularly long term interest rates, are not even mentioned. High levels of real interest rates depend, according to Friedman, only on a high variability in the growth of monetary aggregates. Secondly, in a table (Table 1, p. 75), Friedman shows the rates of growth of M1 and M2 in various subperiods of very short duration (about six months on average) and, with a lag of only three months, the rates of growth in nominal income and the variations in the short term interest rate. The table shows a high positive correlation between rates of growth of monetary aggregates on the one hand and of nominal income and rates on interest on the other. Friedman, in keeping with his belief in the quantity theory of money, maintains that the direction of causation is from money to income and to rates of interest. But the quantity theory tends to be valid over a long period of time [6] and, for periods as short as those considered by Friedman, the direction of causation can also be reversed. The short term instability in nominal income observed in the United States during this period could also be due to fiscal policy either directly or, indirectly, through the real interest rate, to the effects of oscillations in the dollar or to cycles of consumption and inventories. If this second hypothesis about the correlations observed in the table is correct, then all Friedman's criticism of American monetary policy is invalid. Thirdly, since the average length of the subperiods considered by Friedman is little more than six months, the rates of growth of money shown in the table have a high seasonal component and they exaggerate the level of instability in monetary growth. Fourthly, during this period there were important innovations in the American monetary-financial sector which

[6] See R. LUCAS Jr., «Two Illustrations of the Quantity Theory of Money», *American Economic Review*, Vol. 70, December 1980, pp. 1005-1014, and A. SOMMARIVA - G. TULLIO, «An Annual Macroeconomic Disequilibrium Growth Model of the German Economy (1880-1979)» in A. SOMMARIVA - G. TULLIO, *100 Years of German Economic History: A Study of the Effects of Economic Policy on Inflation, Currency Depreciation and Growth*, Macmillan, London, 1986.

contributed to a certain instability in the demand for money, particularly M1. Moreover, in the second half on 1982, for which the highest rates of growth in the monetary aggregates were observed, the Federal Reserve had slackened the reins of its monetary policy perhaps because of the problem of the indebtedness of the developing countries and the dangers of instability for the American banking system and, in my opinion, it did well to do so.

On the whole, therefore, I do not think that Friedman's criticisms of the Federal Reserve are justified while Parkin's criticism of the Bank of England is more convincing.

It would have been interesting if the book had included a chapter on the monetary policy of the Federal Republic of Germany, for two reasons. First, the Bundesbank was, probably, the most « monetarist » of all the Central Banks of the principal industrialised countries and, secondly, and regardless of whether it was actually monetarist or not, it certainly was more effective than Italy, Great Britain or the United States in keeping inflation at relatively low levels.

GIUSEPPE TULLIO

*Commission of the European Communities, Brussels*