THE QUEST FOR MONETARY STABILITY

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Comments

Giuseppe Tullio [1]

Changes in the Italian Monetary Constitution, 1979-94

Mr. Passacantando carefully analyses in the first part of his paper (Section 4.2) the changes in the Italian monetary constitution that were implemented between 1979 and 1994 and the consequences these changes had for the Banca d'Italia's capability to control effectively monetary aggregates. The paper is well written and contains a wealth of information which is not easy to find (for instance I was struck by the quarterly data on the excess demand for Treasury bills plotted in Fig. 4.5 which show that, even during the bad exchange rate crisis of 1992, demand always exceeded supply, and that during 1993 and the first two quarters of 1994, when the problems of financial instability seemed all but over, demand kept increasing with respect to supply until the cover ratio exceeded 150 percent). His emphasis in the analysis is on short run monetary management as it should be for a central banker; this leads him to devote a lot of attention to gradual changes in the auction system of Treasury bonds and bills and to the development in the course of the decade of the secondary market for Treasury debt.

The main conclusion of the first part of his paper is that the Banca d'Italia was unable to effectively control monetary aggregates during most of the 1980's, despite the July 1981 "divorce" between the Treasury and the Banca d'Italia and hence to take full advantage of it until the following reforms were implemented: a) the auction system was changed in the course of the 1980's; b) the Bank gained full control of discount rate changes in 1992 ; and c) the very large overdraft facility of the Treasury at the Bank (14 percent of planned government expenditures) was abolished on December 31, 1993. I do agree with his main

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conclusion, as long as we limit it to the Bank's capability to effectively control monetary aggregates in the short run.

However, for the control of inflation, which is what we are ultimately interested in, short run deviations of monetary aggregates from some announced or unannounced target do not matter that much, provided they can be reversed, given the long lags with which monetary policy affects inflation. What is important is the controllability of money beyond, say, the quarter. For this longer term controllability, changes in the auction system and the development of the screen-based market for Treasury debt matter relatively little, as long as Finance Ministers, with whom rested the ultimate decision to change the discount rates until 1992, were willing to change it to prevent an exchange rate crisis, which in general they were. On the contrary, the fixed exchange rate constraint of the European Monetary System (EMS), coupled with the lack of short run controllability described by Mr. Passacantando, may even have led the Bank and the Finance Ministers to keep real interest rates on average at higher levels than they would have otherwise kept them, in order to minimize the risk of a Treasury financial crisis. In my opinion, long run controllability of monetary aggregates was achieved in July 1981, if not already before.

The "Divorce" and Structural Break

Another closely related conclusion of the first part of the paper is that the July 1981 divorce did not really represent a "structural break" in the monetary constitution. In a paper with Marcio Ronci, I estimated a reaction function of Italian monetary authorities from 1971 to 1991 in which the rate of growth of M2 is explained by three variables: the budget deficit in percent of GDP, the potential output gap, and the current account in percent of GDP lagged two quarters (Ronci and Tullio, 1994). We found a very significant change in the degree of monetary financing of the budget deficit on the part of the Banca d'Italia at the end of 1977. The degree of monetary financing fell by about 60 percent, but it remained still significant after 1977. No breaks are observed thereafter, neither in the degree of monetary financing or in the other coefficients. Thus our estimates indicate that the actual behavior of the Banca d'Italia did not change in 1981 or thereafter. As suggested by the recursive parameter estimates, once the 1977 break is taken into account, the reaction function is surprisingly stable and well behaved.

Returning to Mr. Passacantando's conclusion about the lack of structural breaks in 1981, I therefore agree that there was no significant change in actual behavior of the Bank in 1981 or thereafter; however, I consider the divorce as a significant change in the monetary constitution, although the Bank did not make use of its greater independence, as shown also by the very slow decline in the amount of Treasury bills purchased at auctions (Fig. 4.3 of the paper) and by the estimates of the reaction function by Ronci and myself (1994 and 1997). I expect, however, a major break in the actual behavior of the Bank sometime after 1992, after full independence had been reached, with more attention being devoted to inflation (the latter was not significantly different from zero in the Banca d'Italia's money supply function estimated by Ronci and myself) and less importance being devoted instead to the passive monetary financing of cyclical upswings (the output gap has a significant and positive coefficient in the 1971-91 estimates, suggesting some degree of destabilizing behavior on the part of the Bank).

Decline of Inflation in Italy and the EMS

In the second part of the paper (Section 4.3) Mr. Passacantando analyses the causes of the decline of inflation in Italy from 1979 to 1986 and of its up and down swings from 1987 to 1994. He divides the period into three subperiods: the EMS period with frequent realignments (1979-86), the EMS with fixed exchange rates (1987-August 1992), and the flexible exchange rate period from September 1992 onwards. Particular importance is correctly attributed to the exchange rate constraint and to the import of credibility from Germany in helping Italian Monetary authorities to pursue anti-inflationary policies and the Italian Government to convince labor unions to de-index wages. The two parts of the paper are, however, not sufficiently linked. How did the changes in the monetary constitution analyzed in the first part of the paper (the 1981 divorce, changes in the auction system and the development of the screen-based secondary market for Treasury debt) affect the determinants of inflation and in particular the controllability of money beyond the short run? How did they influence the credibility of the exchange rate system and of the anti-inflation stance of the Governments? These questions are either not discussed or barely touched upon.

Mr. Passacantando's subdivision of the whole period gives the impression that what really mattered, in his opinion, for the control of

inflation in the 1980's was the exchange rate system and the way the system was managed by Italy and its EMS partners, rather than the short run controllability of money discussed in the first part of the paper.

On the issue of the role played by the exchange rate in the 1979-86 disinflation, I agree with Mr. Passacantando that it was very important, although I would have preferred a split in 1983-84 rather than in 1986-87. Most econometric studies on the increasing credibility of the EMS in the 1980's seem to indicate that the EMS became "credible" not much after the so-called French U-turn of March 1983. This is confirmed by a study by Eelke de Jong on expectations of selling prices in EMS countries (De Jong, 1994) and by a study by Patrick Artus and Roul Salomon on French inflation and French-German interest rate differentials (Artus and Salomon, 1994). In addition, in the above mentioned study, Ronci and I found, using recursive parameter estimates, that the determinants of Italian inflation changed around the beginning of 1983. The quantity theory — amended to take into account oil-price shocks, the business cycle and tax increases — works surprisingly well from 1971 to the first quarters of 1983 with money being very significant. After that, only oil prices and current and lagged German inflation matter, with money losing all explanatory power. Money became probably endogenous after 1983, as suggested by Mr. Passacantando for the period after 1986. In addition to the greater credibility of the EMS after 1983, the slow changes in the Treasury bill auction system and the development of the secondary market for Treasury bills described by Mr. Passacantando also may have contributed to the 1983 shift in the determinants of Italian inflation.

What failed in Italy after 1986 was not monetary policy or exchange rate policy; it was above all fiscal policy. The fiscal expansion of the 1980's explains most of the acceleration of inflation after 1986, especially of non-traded goods prices, as pointed out by Mr. Passacantando (see also Micossi and Papi, 1994). The share of government expenditures in GDP increased remarkably and it is now 58 percent (and almost 80 percent in the South). Taxes had to follow the rise of expenditures. The South of Italy comes today close to being a (very badly managed) centrally planned economy. The primary fiscal deficit kept falling in the course of the decade and so far in the 1990's; however, I feel that the changes in the share of government expenditure in GDP are a much more reliable indicator of the stance of Italian fiscal policy.

In the 1980's most economists in Italy hoped that, sooner or later, the exchange rate constraint would bring also fiscal policy into line;

instead, the exit of the lira from the exchange rate mechanism of the EMS in September 1992 and the large devaluation which followed was more effective than the fixed parity with the DM because it scared politicians and induced them to act. What was missing in Italy in the 1980's was a constitutional limit to the growth of government expenditures.

Lessons for Brazil

I conclude with some very tentative lessons one can drawn from the Italian experience for Brazil. The first one is that the pegging of the exchange rate to the currency of a low inflation country can be a powerful instrument to keep monetary growth and inflation under control, but it only works in the long run if fiscal policy is compatible with the exchange rate constraint. The second is that a sound monetary constitution probably also requires some legal or constitutional limit to fiscal debts and deficits vaguely resembling the conditions the Germans have imposed at Maastricht on their potential partners in the European Monetary Union. The third is that Brazil may gain a lot if it had a fully independent central bank and, most importantly, made price stability the central bank's sole legal responsibility. Changing the monetary constitution only gradually and partially in the direction of greater autonomy of the central bank, as Italy did in the last 15 years, may not be the best way to solve the reputational problem of an inflation-prone country. The 1992 suspension of the Italian participation in the exchange rate mechanism of the EMS ocurred ironically just before Italy had almost completed the slow reform of its monetary constitution. Had the Banca d'Italia possessed already in 1981 the degree of independence it enjoys nowadays, a strong governor might perhaps have been able to force fiscal adjustment on the Government and the Parliament without the need for a major exchange rate crisis. I am therefore fully in agreement with Passacantando, Goodhart and others that full autonomy of the central bank is what an inflation-prone country needs to solve its reputational problem, although, as several participants have emphasized, this is neither a necessary nor a sufficient condition for low inflation.

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