Public Deficit and Monetary Course Change in Italy since 1981

By Mario Arcelli

The paper aims: a) to give a description of changes in the *modus operandi* of monetary policy in Italy since 1981; b) to raise questions regarding the evolution of money markets and the banking system after the modifications in monetary policy intervened since then. The elimination of the ceiling on bank lending in 1983 was the last step towards a shift from administrative forms of credit control to indirect forms. What are the reasons for the switch? Can this change be reconciled with the size and evolution of the public deficit? The paper attempts to provide an answer.

1. The Changing Course of Monetary Policy

Monetary policy is changing course in Italy, gradually but steadily. What will this bring and how far can it go? How can this change be reconciled with the size and evolution of the public deficit? These are undoubtedly the questions that need to be answered in order to examine the changes in the monetary authorities' operational and intermediate objectives, in the reactions and strategies of banks and other financial intermediaries, and in the effects on interest rates and the money markets. However, before tackling these questions it is necessary to define exactly what is meant today by a monetary course change.

In the second half of the seventies considerable changes took place in the behaviour of the monetary authorities of the major countries; and the high and variable inflation resulted in the objective of stabilizing interest rates having to be abandoned and suggested the switch to intermediate objectives of a quantitative kind, including targets for monetary aggregates, such as M1 and M2, or, in some countries, for credit.

Considering just this aspect it could be said that Italy preceded other countries with its monetary course change when it switched in 1974 from its policy of interest rate stabilization, which had characterized the Bank of Italy's action in the sixties, to a policy based on an intermediate objective for total domestic credit (TDC).

Albeit somewhat schematically it can be claimed that a Keynesian monetary policy sets out to control interest rates because they are seen as the main links in the mechanism of monetary policy transmission. Thus the switch to a quantitative objective instead of a price objective such as interest rates is undoubtedly a move away from that theoretical position. And the failures of Keynesian economic policy with regard to inflation go a long way towards explaining the widespread change in the views of monetary authorities.

However, the priority given to the objective for total domestic credit rather than a quantity of money objective implied an underlying logic still of a Keynesian rather than a monetarist kind. Indeed, not only was there assumed to be a high degree of substitutability among most financial assets, which was supposed to make the relationship between TDC and the effective demand more stable than that between the latter and money or bank credit (DCE), but the process of balance-of-payments adjustment implicit in the model adopted also reflected a largely Keynesian logic.

In fact the appearance of an imbalance in the financial assets market as a consequence of a balance of payments deficit had effects on income via the multiplier since it reflected a difference between saving and investment.

Even though external adjustment could also be achieved by attracting funds from abroad to offset the current account deficit, the principal adjustment mechanism acted through the rationing of credit, which reduced the scope for investment and thus changed the level of income and the related volume of imports.

There was a very different course change in the U.K. and the U.S., not only because a money rather than a credit intermediate objective was chosen but above all because the approach became decidedly monetarist. Up until 1979, U.S. monetary policy was primarily based on money market interest rates. The aim was to keep the change in the Federal Funds rate, which is the leading money market rate, within a narrow band. The monetary authorities also gave indications with regard to M1 and M2 but fixed much wider ranges, which, in any case, were not binding.

However, when inflation became rampant and interest rates rose inexorably, a monetary policy based on interest rates no longer answered: such a policy itself tended to be inflationary.

In October 1979 there was the so-called "new course" in the monetary policy of the Federal Reserve, whereby the operational aim was no longer to hold the Federal Funds rate steady but to regulate bank reserves in such a way as to achieve the intermediate objective of a given growth rate of M1 and M2 within a narrow range.

The setting of quantitative objectives for monetary aggregates seeks to provide a consistent monetary answer to inflation. It reflects awareness that slowing down the rate of growth of the money supply is a necessary condition for a recovery of price stability.

2. Credit Restriction versus base Control

What happened in Italy during this period and in what sense is it possible to talk about a new approach on the part of the Italian monetary authorities indicating a desire for a course change?

The initial reaction of the Italian monetary authorities to the second oil crisis (1979 - 80) was to reaffirm the need to strengthen the ceiling on bank lending in order to adjust the external imbalance via total domestic credit, or at least to curb its deterioration.

The surge in the public sector deficit that occurred at this time forced the authorities to offset the larger volume of lending to the public sector by reducing that to the economy. This was achieved by tightening the administrative constraints on the disbursement of bank loans. The TDC intermediate objective had proved to be appropriate in an emergency, when what is needed is rapid and effective action to correct a serious disequilibrium in the balance-of-payments. Rationing credit has a much more immediate impact than increasing interest rates, since the effects of the latter appear more slowly, and not only because of the time materially required to implement a restrictive monetary policy but also because of the rigidity of the demand for credit with respect to the level of interest rates. Furthermore, with rationing one prevents interest rates from reaching the excessively high levels needed for price to adjust demand down to the reduced supply of credit. In many cases a similarly excessive rise in rates could jeopardize the orderly working of the financial markets.

In 1980 and 1981, however, the tightening of the ceilings on bank lending contributed to some bank credit being replaced by lending by the special credit institutions, whose range of operations was also extended through institutional innovations that imply substantial changes in the working of the credit market. The monetary squeeze, concentrated as it has been on the banking system, has also stimulated the creation of a series of parallel credit channels to which the banks have contributed through the development of banking-related services, the introduction of innovations and the expansion of credit guarantees.

As time has passed the monetary authorities have therefore had to tackle new problems. The reaction of the banking system to the tightening of administrative constraints on credit and the progressive expansion of the public deficit have gradually reduced the controllability of the TDC intermediate objective. On the one hand this has been due to the divergence of public expenditure from its planned path — it being impossible to completely offset its overshoot with reductions in the finance granted to the economy — while on the other even the ability to control credit channels with administrative instruments has gradually diminished owing to banks getting round the ceilings on their lending in the ways described above.

On top of this there have been increasing distortions as a consequence of the rationed allocation of credit. This has primarily been to the detriment of the productive sector and within this of the soundest companies.

From another point of view, the expansion of the public deficit, which has been especially fast since 1979, has made it necessary to review monetary strategy. There was, in fact, the danger of an excessive amount of monetary base being created to satisfy the growing Treasury borrowing requirement or, when it was desired to limit the creation of monetary base, interest rates had to be raised and made highly fluctuating in relation to the different responses of the market at different times. This dilemma could not be overcome in terms of TDC by itself. The composition of financial assets that is generated by a given level of TDC is compatible with several levels of banking intermediation and hence with several levels of money supply. For a given value of TDC the quantity of money created will be different according to whether government securities are placed largely with the Bank of Italy, purchased directly by the public, or taken up by the banks, thus increasing intermediation. But it is also true that different amounts of open-market operations by the monetary authorities and bank intervention in the securities market are not incompatible with a given amount of TDC. Hence the need always to consider the quantity of money that is created in correspondence with the planned TDC in view of its effects on price inflation and the balance-of-payments.

These two problems, the weakening of direct credit controls and the need to curb the creation of monetary base, gave rise to a series of changes in the *modus operandi* of monetary policy. During 1981 and 1982 the latter was restrictive, even though total domestic credit followed a relatively accomodating path. The expansion of credit was accompanied by high interest rates in both nominal and real terms. The need to place an ever larger volume of government securities in order to finance the expanding public deficit forced the authorities both to curb credit to the economy and to offer savers a real yield that would match the supply and demand for securities. Monetary policy became more restrictive even though TDC expanded. This was due both to the restrictions imposed on the private sector with the aim of partially offsetting the growth in public sector borrowing and to the rise in interest rates produced by the curb on monetary base. The channels of monetary policy transmission are no longer identified almost exclusively with the availability of credit but are increasingly related to the real interest rate. This explains the attention paid by the monetary authorities to a broader range of real and monetary aggregates and variables.

This new stance of monetary policy is also the result of the increasing attention paid to inflation by both economic agents and the monetary authorities. Inevitably the control of liquidity comes to have priority even over the control of credit. This explains several of the steps in the change of monetary strategy. In the first place the "divorce" between the Treasury and the Bank of Italy in 1981, which allows the Bank of Italy to separate its responsibility for the creation and control of liquidity from the budget and Exchequer policy. This choice does not signify, however, that the Bank of Italy gives absolute priority to the control of the monetary base and accepts absolutely any fluctuation of interest rates. A careful watch is kept on their level and structure, but the Bank nonetheless refrains from stabilizing rates at the cost of uncontrolled growth in the monetary base. On the one hand the size of the continually expanding public deficit makes the latter increasingly difficult to finance, on the other, it makes rules of behaviour necessary to prevent control of the monetary base being lost.

After the divorce another step along the road of monetary policy change consisted in the decisions taken by the authorities at the end of 1982, and especially the new regulations regarding compulsory reserves. The monetary authorities had judged the growth in bank deposits in the second half of 1982 to be too dangerous in view of their inflationary potential and chose a path that would slow down this growth. From a structural point of view, the higher compulsory reserve coefficient on deposits and the powers to make variations assigned, within certain limits, to the monetary authorities revealed the aim of shifting the control of the banks' balance sheet. This also emerged clearly in the measures that extended the compulsory reserve coefficient to repurchase agreements, which allow banks to raise funds outside the normal channels through the temporary sale of securities to customers, and, on the asset side, reduced the compulsory security investment requirement, which requires banks to purchase securities issued by the special credit institutions. The obligation to replace these securities as they matured was also eased. Finally, a special measure aimed at consolidating the banks' liabilities by encouraging the issue of certificates of deposit. These measures were preparatory to the elimination of the ceiling on bank lending that was to be implemented at the end of June 1983.

3. The new Transmission Mechanism

This was the final phase of a process that had been pondered at length by the monetary authorities, who appear to see the switch in monetary policy as a positive alternative to increasingly extensive and suffocating administrative controls.

Already in 1981 a lucid and farsighted analysis of the problem by Governor Ciampi had stated that "if we want to avoid weighing even more heavily on the part of financial flows that are directly controlled and if, on the other hand, the conditions permitting administrative controls to be abolished do not develop, it will be necessary to extend, rather than narrow, the range of financing subject to control. In the long run there is a contradiction between extending the money market to include credit instruments designed to promote the financing of firms by savers and a monetary policy strategy relying permanently on direct controls.

Moreover — Governor Ciampi went on — even when the action of the central bank is based exclusively on the regulation of bank reserves and relies for its effectiveness on the ability of interest rates to influence the demand for credit, a broader range of financial instruments and more diversified markets reduce the accuracy and speed of the effects of monetary policy compared with a situation in which bank credit accounts for a large proportion of the financing of the economy. These drawbacks are less serious if changes in interest rates become more fluid and hence influence the expansion of credit more rapidly owing to markets being more efficient."[1]

This passage would suggest that credit to the economy, rather than the money supply, is the transmission mechanism that the monetary authorities still consider to be most important, even though the problems could appear in a different light in the future if there were greater diversification of the money and financial markets. This indication was recently confirmed by Fazio and Caranza at a conference held in Perugia to examine the political economy of monetary policies of the major countries.[2] In Italy the limited de-

[1] *Ciampi* (1981).
[2] *Hodgman* (1983).

velopment of the money and financial markets compared with the greater efficiency of the credit market is considered to reduce the importance of the money supply as a channel for the transmission of monetary impulses. Fazio and Caranza nonetheless admit that the importance of the composition of financial assets should not be underrated because monetary impulses are propagated not only through wealth effects but also by the chain of substitutions in financial portfolios.

According to this interpretation, the course change made by the Italian monetary authorities concerns the instruments for the control of credit aggregates rather than the intermediate objectives of monetary policy. The degree of credit restriction is not the same thing as the instruments employed to obtain it. The shift from administrative forms of credit control to indirect forms, through greater market participation is held to be the key aspect of the policy change. It is in this context that importance is taken on by control of the monetary base to achieve the level of interest rates that will curb the credit disbursed to the economy within the limits consistent with the intermediate objective adopted.

In short, what Fazio and Caranza claim is that "the Bank of Italy sets itself an operational target in terms of monetary base, which determines the level of a key rate, that on Treasury bills. In equilibrium, every level of this rate corresponds to a given rate of increase in bank credit and deposits. The intersection of the supply and demand schedules for bank loans determines the bank lending rate and the shares of credit to the public and private sectors. Although it is always positive, the causal link between monetary base and total domestic credit is not rigid and acts via interest rates.

If, instead, the aim was to influence only the money supply, there would have to be a tighter control of the monetary base and in particular of bank reserves. The changes that would occur in the level and structure of interest rates as a result of the change in the supply of money would gradually spread throughout the system."[3]

However, real interest rates acquire a strategic role in monetary policy management not only in connection with credit control but also as a means of stimulating the propensity to financial saving.

Furthermore, in relation to the varying size of the Treasury borrowing requirement they contribute to the achievement of equilibrium in the money and foreign exchange markets.

[3] *Fazio* and *Caranza* (1983).

At this point it can be seen that the steps taken towards making monetary aggregates more and more important have been neither few nor small.

As it was recently pointed out, the emphasis placed on interest rates as a mechanism for exerting control and transmitting monetary policy raises questions with regard to the claimed greater importance of the credit market compared with the money market. How is the choice to be made between a monetary base-money supply relationship and the alternative monetary base-credit relationship?

We have seen the reasons why it is no longer satisfactory to adopt TDC as the intermediate objective of monetary policy; basically they can be traced back to its limited controllability and to the lack of stability of the relationship between intermediate objective and final objective. On the other hand there is no evidence at present to suggest that for Italy adoption of a quantity of money intermediate objective, whether M1 or M2, instead of a credit objective would lead to a substantial improvement in achieving final objectives.[4] There is, however, clear evidence that role of the money markets is growing in importance: the differential between bank deposit rates and that on Treasury bills has become a major element in the regulation of the degree of bank intermediation since the public is increasingly sensitive to the yields on alternative assets. The Treasury bill market, supplemented by the Bank of Italy's repurchase operations, has become the strategic element in the control of liquidity. This is important both for the fight against inflation and for the control of the foreign currency reserves.

The Bank of Italy appears to take a total volume of monetary base as an operational hypothesis and therefore tends partially to offset any excessive destruction of monetary base via the foreign sector channels. If, on the other hand, the foreign sector creates monetary base, the bank tends to curb the creation of monetary base by the Treasury. In coherence with the latter case, during the first nine months of 1983 the Treasury did not create monetary base and nonetheless managed to place more securities in the market than forecast, thereby neutralizing most of the monetary base created by the foreign sector. This behaviour, as it was pointed out, is worth analyzing since offsetting or neutralizing, according to the case, the external component of the monetary base by means of the domestic component is not without effect on money market interest rates and hence on the foreign currency reserves. It is sufficient to recall the analogy with the "DCE model" which prescribes that the foreign component of money must not be offset or neutralized by the domestic component.

[4] See, for example, *Dennis* (1983).

Recently the Bank of Italy appears to have offset the destruction of monetary base by the foreign sector only partially, while it has fully neutralized the monetary base created by this channel. Concern with safeguarding the foreign currency reserves and rebuilding them during favourable periods appears to be an adequate explanation of this behaviour and underscores the role of interest rates, not only for the domestic purposes of regulating the monetary and credit aggregates, but also for reasons of external equilibrium.

There is naturally the danger, as explained in last year's "Concluding Remarks", that in a period of stagnation or slow growth positive real rates may outstrip the rate of growth of the economy and prove unsustainable in the long run because they give entitlement to an income that the economy does not actually produce. If corrective action is not taken to curb the Treasury borrowing requirement, the task of monetary policy will become extremely arduous. On one hand the monetary authorities would be failing in their duty if preoccupation with minimizing the cost of public and private borrowing led them to accept the monetization of the debt by accelerating the creation of monetary base and thus creating a spiral of inflation, external deficits and devaluation. On the other hand, adoption of rigid monetarism could, however, lead to an equally dangerous situation. High interest rates on the public debt would increase the public sector borrowing requirement, while they would bring unemployment and investment down to unacceptable levels.[5]

One can only agree that the Bank of Italy was right to eschew rigid monetarism, and on theoretical grounds as well. Financial innovations and monetary policy interact, as experience in the U.K. and the U.S. clearly shows. The significance and composition of the monetary aggregates is changing and they appear to provide a shakier foundation upon which to build a monetary policy.[6] There nonetheless does not appear to be solid evidence, in cases of variations in the velocity of circulation, to support the view recently put forward that the growth rate of nominal GDP is a better economic policy intermediate objective than the growth rates of monetary aggregates.[7]

For the moment the degree of financial innovation in Italy is still relatively limited, but considerable change in the markets is in sight, as regards both the modus operandi of the special credit institutions and other financial intermediaries and the deposit and lending policies of the banks.

[5] *Ciampi* (1983).
[6] See *Akhtar* (1983).
[7] See, for example, *Bean* (1983), *Basevi / Blanchard / Buiter / Dornbusch / Layard* (1983).

However, even in today's situation, given the inadequacy of single quantitative intermediate objectives as a basis for rigid monetary policy rules, it would appear helpful when monitoring monetary conditions to give flexible consideration both to several aggregates and to interest rates, rather than concentrating on the symbolic value of just one variable. This is not to deny the usefulness of a reference framework giving bands of compatibility and consistency among variables as well as indicating the stance of monetary policy. The multiplicity of objectives and instruments nonetheless makes it necessary not to oversimplify the links relating a set of instruments to a given group of objectives.

4. Consequences for the Strategies of Banks and for the Public Sector

The elimination of the ceiling on bank lending in the middle of 1983 represented a change in monetary policy to the advantage of the banks. It is true, of course, that the initial effects were not, and could not have been very pronounced because the monetary authorities replaced the ceiling with moral suasion in order to keep the growth in bank lending in 1983 within the amount planned at the beginning of the year. Independently of this initial phase, however, provided the surging public deficit does not make new controls inevitable, the abolition of the administrative constraints on the Banks' balance sheet assets will intensify competition between banks, and between them and the other financial intermediaries, and in the future could lead to large structural changes. Starting from the beginning of 1984, the Bank of Italy has decided to restore full freedom in bank lending, keeping, however, a monitor of the evolution of the credit market. The banks are already adapting their strategies to the changed outlook, while the monetary authorities are faced with the difficult task of shifting gradually and without upheavel from the direct control of the banks' assets to an indirect control of credit, to be exercised primarily through regulation of the monetary base. We are on the threshold of a period of transition, during which the development of bank lending will still be influenced by its present structure, but during which individual banks' ability to compete and expand will gradually emerge, both through the adoption of more flexible policies for interest rates, credit instruments and beneficiaries, and through new policies for deposit interest rates that will inevitably distinguish more sharply between liquidity and savings. A recent survey conducted by *Tendenze Monetarie* revealed, on the one hand, a fall in the share of bank credit accounted for by loans during the ten years of administrative constraints on the banks' assets and, on the other, the steady shift of bank loans away from public enterprises and large private firms towards small and medium-sized firms and individuals. This structural change was largely due to the ceiling, both directly because it restricted supply and indirectly because of the changes it induced in firms' behaviour, since they diversified their sources of external financing, to an extent that varied with their size. In turn, the economic crisis worsened the quality of lending.

It is therefore probable that the abolition of the ceiling will lead to a substantial redistribution of banking intermediation. Given the present distribution of branches, however, some banks will be in a better position than others in the new competitive conditions and it will take time for a new equilibrium to develop with the credit system on a new structural basis.

If the banks really wish to exploit the opportunities inherent in the abolition of the cealing on lending, they will have to introduce far-reaching innovations also in their fund raising and create new forms of financing of the economy.

Not only does it appear advisable that fund raising should be diversified so that sight deposits (transaction instruments) will be remunerated differently from savings and time deposits, but with the prospect of a future extension of the market careful consideration should be given to mixed forms such as those in the U.S.

Closer to hand, new developments are foreseeable in the interbank market, which will have to be reassessed, particularly from the point of view of the problems it poses for the indirect control of credit. There is an interesting outlook for the relations between banks' cash management, their lending policies and the interbank market.

The issue of certificates of deposit appears destined to expand in the interbank field. Banks' deposits will become more reactive to interest rates. Changes in the interest rates on certificates of deposit and in the interbank market will influence the lending rates.

If these tendencies develop, there will be greater competition between the banks and between them and the other financial intermediaries, and the whole market will be made more sensitive to the changes in interest rates triggered by monetary policy and the behaviour of economic agents.[8] The greatest obstacle to such a development of the money and credit markets is the growth of the Treasury borrowing requirement. If the need to channel saving towards the public sector should continue to dominate monetary policy, there will be less and less room for manoeuvre for the banks and the other financial intermediaries,

[8] *Arcelli* (1982).

and there would be little or no use in trying to expand the scope of the market with the search for new channels and more efficient forms for the conversion of saving to investment.

Forecast of the public sector borrowing requirement in 1984 and subsequent years indicate that the ratio of the stock of financial assets to GDP will arise above the high level that has been recorded at the end of 1983.[9] Another point that cannot be overlooked is that the public debt stands close to 80 % of GDP.

The future course of interest rates will be strongly influenced by the financing of the public sector borrowing requirement and the objective the authorities will set for the monetary base. There is the danger that a partial monetization of the public debt, caused by the difficulty of substantially increasing the amount of financial assets held by the public, will rekindle inflation. Should monetary base formation be kept tight, then another danger is that new pressures will push up real interest rates, a development that would suffocate the recovery.

If new effective measures to reduce the structural deficit of the public sector are not taken soon, all the efforts that have been made to repristinate market mechanisms in the credit sector are bound to be practically nullified. And the remedial action will have to be both drastic and painful.

Summary

The article deals with the following problems:

— The change in intermediate targets of monetary policy during "the seventies"
— The "new course" of monetary policy in Italy after the second oil shock
— The "divorce" between the Treasury and the Bank of Italy; new regulations of compulsory reserves; elimination of ceilings on bank loans
— The new mechanism of transmission of monetary policy and the role of interest rates
— Stronger competition between banks and other financial intermediaris
— New strategies for the banks and wider scope for the market
— Necessity of a structural cut of public sector borrowing requirement.

Zusammenfassung

Der Artikel behandelt die folgenden Probleme:

— Der Wechsel der Zwischenziele der Geldpolitik während der 70er Jahre
— Der „neue Kurs" der Geldpolitik in Italien nach dem zweiten Ölschock

[9] *Masera* (1983).

— Die „Trennung“ zwischen dem Schatzamt und der Bank von Italien; neue Bestimmungen hinsichtlich der Mindestreserven; Eliminierung der Höchstgrenzen für Bankkredite
— Der neue Transmissionsmechanismus der Geldpolitik und die Rolle der Zinssätze
— Stärkere Konkurrenz zwischen den Banken und den Kreditvermittlern
— Neue Strategien der Banken und weiterer Spielraum für den Markt
— Die Notwendigkeit einer strukturellen Kürzung der Erfordernisse für Kreditaufnahme der öffentlichen Hand.

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