EUROPEAN UNIVERSITY INSTITUTE, FLORENCE

DEPARTMENT OF ECONOMICS

E U I W O R K I N G P A P E R No. 64

ITALIAN MONETARY POLICY IN THE 1980s

by

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Paper presented at the Symposium on 'Discretionary Economic Policy Versus Rules', Vienna, 22 September 1983

BADIA FIESOLANA, SAN DOMENICO DI FIESOLE

Printed in Italy in September 1983
European University Institute
Badia Fiesolana
50016 San Domenico (Fi)
Italy.

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In the course of the 1970s the Italian economy was severely destabilized by a series of external shocks, which also similarly affected other European economies. First, the end of the Bretton Woods era and the Dollar's departure from its gold parity, then the world inflation which the dollar devaluation probably unchained and the ensuing jump in oil and raw material prices made more violent.

Those external shocks put into a greater relief the structural inflation ever present in a fast developing country like Italy. As a result, the Italian economy was absorbed into a vortex of devaluation, followed by inflation and further devaluation, which had hitherto been typical of Latin American countries. From that vortex, into which even the most developed countries were attracted for a short while, the Italian economy has not yet been able to emerge. In spite of Italy's membership of the European Monetary System, the deflation issuing from the core of that system has not spread to Italy. The Italian economy has switched into low gear for what concerns industrial production and GNP, but is still enmeshed in a vicious circle of devaluation and inflation.[1)] The present depressed situation of the world oil market and of other commodities markets, together with the already mentioned recession of GNP and industrial output have only managed to keep the growth rate of consumer prices within the bounds of 15-16%, which one has to compare with the 2-3% now prevailing in Germany and Japan, the two other fast growing economies Italy used to be compared with.

The possibility that a model of structural inflation be more appropriate in the interpretation of recent Italian economic history must therefore be examined seriously. In spite of a deflation of GNP which is now in its third year, prices have kept growing at the mentioned rates.

A comparative analysis of structural inflation has been carried out by the research department of the BCI and published in a recent issue of its bulletin.[2)] It used the 1975 input-output tables for the main European countries with the aim of isolating the inflationary push issuing from an external shock, its propagation through the sectors of the economy, and its multiplication by means of indexing mechanisms available to protect labour and capital income, and by fiscal mechanisms introduced by governments. The end product of the analysis is the isolation of the external determinants of inflation and of the inflationary impact of income distribution changes.

The outcome of the mentioned study is the following:

1. The Italian productive structure has a greater content of intermediate imports than that of Germany, France and the U.K. In addition, final demand is more oriented, in Italy, towards goods with a high import content. As a result Italy is more sensitive than Germany, France and the U.K. to a change in the prices of imports.

The Italian economy is also the most sensitive to changes in the prices of raw materials, particularly oil and other energy products. And, in Italy alone in the sample, families' consumption shows a higher inflation rate than total demand. In addition, if we isolate the inflationary effect of a rise in energy prices, consumption prices and exports' prices are affected in Italy more than in the other countries of the sample. The only other case is Holland, where exports consist for a large part of energy products.

2. The inflationary potential of an exogenous rise in wages and salaries is smaller in Italy than in the other countries of the sample. In addition, the inflationary effect of a rise in wages and salaries on consumer prices is for Italy the lowest of the whole sample.

3. The opposite is true for the inflationary effect of rises in incomes other than labour, both for consumption and total demand. This is the highest of the whole European sample. The explanation can be found in the fact that in Italy the "self employed" represent a much higher share of total employment than elsewhere in developed Europe, and that they are as a result a much heavier component of "other incomes". In addition the inflationary impact of the service sector is, in Italy, much greater than in the other countries of the sample. The inflationary impact is particularly marked on the consumption deflator.

4. The inflationary impact of changes in social security charges is also highest in Italy, where such charges are the highest of the European sample.

On the strength of their intersectoral analysis of inflation in Italy and other European countries, the economists of BCI advance an interpretation of the inflationary mechanism in Italy, which is worth summarizing, since I find it very hard to disprove. They say that higher social charges, higher imports of intermediate goods, and raw materials and a heavier tertiary sector with a higher inflationary potential, are the core of Italy's structural inflation. The main channel through which structural inflation operates in Italy is foreign trade. When raw material prices rise, production costs increase for most firms and the trade balance deteriorates, while imports remain unchanged in volume. The inflationary impact thus produced induces a widening of the inflation differentials between Italy and its competitors; exports tend, as a result, to contract, and the trade balance worsens. Inflation is further reinforced by the behaviour of entrepreneurs, who try to beat inflation by raising their own prices more than proportionately, as they expect a devaluation of the Lira. Production costs are increased by the indexation of wages, which is ignited by the mentioned rises in prices. When inflation has taken place, it shifts output towards exports, and exports have a higher import content than domestic demand.

To this analysis I may add that capital movements, when a devaluation is feared, take place at a very high pace, usually taking the shape of underinvoicing and overinvoicing, and to a lesser extent, leads and lags. They show up as reduced exports and increased imports.

We can thus say that a devaluation, operating on a structural background as the one sketched above, sows the seeds of the next one, with the impact on the inflation rate that everyone can imagine.

Why Italy is so peculiarly structured has been the subject of many a study. One can underline, among the explanations available, the one which sees the new Italian inflationary bias as a result of the "industrialization from below" which has taken place in the last decade. As a result of the crisis in labour relations of the early seventies, which coincided with the floating of exchange rates and the oil crisis, Italy entered the new decade with a currency weakened by structural factors (heavy dependence on imported oil) and a crisis of confidence. The large corporations, both private and public, which had led Italy's growth before and after the Second World War, entered a crisis which is not completely resolved even now. Soaring labour costs (social security charges, in particular), a decline in large-firm productivity, and a rise in the protection of labour and in job security, induced a decline in large firms investments and a tendency to de-centralise production. After having built some of the largest plants in Europe, Italian industrialists switched back to the putting-out system. The decline in the exchange rate contributed to shift production from capital back to labour intensive goods.

A decade after, Italy exports proportionately more "early industrialization products" than it did in 1970. Exports are much less concentrated in a few firms, and production now takes place to a much greater extent than it did in small plants and in the colourful network which is usually referred to as the "black economy". Not unlike what has happened in the U.S., industrial production has moved South, especially to the South East and the Center of Italy. Italian industry is now a diffused phenomenon, taking place according to a mode which would have not surprised Adam Smith, but would have certainly surprised Giovanni Agnelli Senior, who built the largest car plant in Europe in 1938.

The crisis of large scale industry, and the rise and diffusion of small scale industry, in the 1970s, has produced most of the causes of the Italian structural inflation. The diffusion of industrial production has meant that the State's capacity to tax the new industrialists is greatly reduced. Equally difficult to tax are the millions of small retail traders who have sprung up everywhere and the millions of "self employed professionals" who have flourished to assist the small entrepreneur and the small trader. Italy's fiscal apparatus has been built on the expectation that, like in other developed countries, most of the employed population would consist of dependent workers, who would pay taxes on the PAYE principle. As the country reverted to grassroot industrialization, a scissor mechanism began to operate. Government expenditures soared, as in every developed country, with the generalization of the Welfare State. But, unlike elsewhere, the receipts necessary to finance those expenditures could be extracted only from the unfortunate lot of the dependent workers, whose numbers were shrinking in relative terms. The network of the black economy,which was growing apace, operated a perfect free raiding.

It used the welfare state, but paid nothing to defray its costs. A government deficit of alarming size was the necessary result of the growing hiatus between the structure of expenditure, which followed the European pattern, and the structure of receipts, which was determined by the new socio-economic configuration induced by the domestic and foreign crisis of the early 1970s.

To finance the growing government deficit, the only way to induce the 40% of "other incomes" recipients to contribute was to offer them government debt, on terms which could be considered satisfactory, indeed appealing. This was done in the second half of the seventies and is still being done. Government debt carries a respectable coupon and is "exempt from all taxes, present and future" as the Government solemnly declares. But Italy's deficit could not be financed "in vacuo". It had to be done in a world where nominal interest rates were being pushed up to hitherto unattained heights by many factors, not least the concurrent growing deficit of the U.S. Government accounts. To the structural factors of the Italian inflation one had soon to add the growing weight of interest changes on total Government Debt, whose average life declined to reach the unprecedented level of less than one year.

Things were not made easier by the Italian decision to take part in the European Monetary System. The EMS did not include either the Dollar or Sterling, or the Swiss Franc, and those three currencies are the most common vehicles for foreign exchange speculation, as they have behind them the most developed financial markets in the world.[3)] Raw material prices are also quoted in

Dollars or Sterling. Thus, when the U.K. and the U.S. initiated their monetary squeezes, as of 1979 and 1980, the Lira depreciated most heavily in terms of Dollars and Pounds, and the Lira-Dollar and Lira-Pound exchange rates were the only ones left to absorb all foreign exchange speculation. If one bears in mind the inflationary potential of imports, especially of raw materials, which we have mentioned earlier, it becomes immediately clear that the impact on the Italian economy had to be shattering indeed. Italy had to pay for imports in an over-valued currency and to sell its exports to countries with under-valued currencies.

To this, which one could already call the worst of all possible worlds, one has to add the political dimension. As of 1979 the Italian "grosse coalition" which included the Communists and which saw us through the cyclone of 1975-76, collapsed. A return to the Center Left followed, which could not take place in an atmosphere of recession and fiscal rigour. The Italian economic authorities chose instead to ride the tiger of the world boom of 1979-80 at full speed, and nothing like a restrictive monetary policy was possible until late 1981. The Italian economy went out of step with the world economy and, as a result, massive foreign credits had to be obtained through the Euro-markets. In addition, to fill its yawning deficit to some extent, the Government had to resort to *ad hoc* fiscal measures more reminiscent of the Middle Ages than of contemporary times.

The foregoing paragraphs were deemed necessary in view of the foreign audience for which this paper is meant, who cannot be supposed to penetrate the socio-political maze within which Italian economic life takes place, and for which Italian monetary policy has to be designed. Before turning to an analysis of the latter, it is necessary to review shortly the transformation that the Italian financial system has undergone in the last decade and to compare it with the transformation Western financial systems have undergone in the same period.

It is useful to recall that financial activities, not unlike other economic activities, can be organised in markets or in firms.[4)] As it is by now clear to students of economic organisations, the firms' system is as much the antithesis of the market system as centralised planning, as it consists of a series of interactions among a hierarchically ordered chain of economic operators which replace the equivalent interactions which take place, on the market, among autonomous economic agents who express demand and supply and generate prices. The larger and less numerous firms are in the system, the smaller the number becomes of transactions that happen on the market place at actual prices.

A country's financial system can develop enhancing relatively more either the mode of markets or of firms. Since the war, national financial systems have witnessed the prevalence of firms over markets, although this has not been necessarily true of the international financial system, and even the internal trend may have been reversed to some extent, in the most recent years. It can, however, be safely asserted that in most countries the post-war period has been characterized by increasing concentration of financial transactions in the hands of fewer and larger firms. This development goes against the forecast of Anglo-American financial theorists, who had expected, by the application of the Darwinian logic, the multiplication of agents to perform on the market place the more numerous and complex functions required by an ever developing society.[5)]

Financial development in most Western countries, however, seems to have followed the opposite path, as more complex transactions have been performed by larger, fewer, multidepartmental, firms, while the area left to markets has progressively shrunk. Things have not been exactly the same in other Western countries, however. In the countries where, in the inter-war years, financial institutions had gone bankrupt, legislation was passed, in the same period, to deliberately reduce the role of markets, to foster concentration of financial institutions and Central Bank control, with the aim of safe-guarding depositors (or, at least, to appear to be doing so). In those countries, the post-war years have seen the development of the opposite trend, towards the unshackling of financial activity from control, and an increased role for markets. The prime example of this were the United States, where a convergence of different interests has favoured, particularly in the last decade, the movement towards decontrolling the financial system, in the naive hope, which is already being given the lie by facts, that the reduction of controls will favour the de-concentration of sectors and the development of markets. Although the move towards lesser control has been more marked under the Reagan Administration, it must be recalled that the Carter Administration embraced, at the time of its inception, a very similar philosophy, and that its actions (when they were not dictated by emergencies) were inspired by a belief in the need for freer and more efficient markets. As to Congress, it seemed for a long while to have become convinced of the preferability of "rules against discretion", although in the most recent period it appears to be shifting into reverse, under the pressure of unfavourable financial events.

In the countries where financial institutions have never been under a cloud of doubt as to solvency and efficiency, as in Great Britain, and especially in Germany, the process of integration of ever more complex financial functions in ever less numerous and larger financial institutions has continued unperturbed (except, for what concerns Britain, for the period of rampant neo-conservatism in the early seventies, when the Central Bank, with the famous policy of "competition and credit controls" let a "hundred flowers blossom" only to be confronted, in a matter of two or three years, with the worst banking crisis this century, the "secondary banking crisis" of 1975).

In fact, in spite of the clash between a more and more concentrated financial structure and the de-centralization wishes of governments and even Central Banks, in the U.K. as well as in the U.S., post-war financial history has seen the reconquest of the market by large firms, who have occupied the space left free by governments after the end of the War. In the early post-war decades, large banks have been able to recover their role of main sources of financial means for industry and trade, by getting rid of the enormous holdings of Public Debt which they had accumulated during the War.[6)] They were, in other words, able to concentrate on asset management, as plentiful liquidity could be obtained by the sale of Government Debt boldings. This phase came to an end around the middle sixties. It has been followed, especially in the U.S., by the phase of "liability management" when banks had to begin looking around for new financial "raw materials". In this phase large banks have been penalized, in the U.S., by the legislation which prevents expansion across State boundaries and thus favours small banks which can have closer relationships with retail savings. In order to keep their market shares, American large banks have developed the C.D. market, and have expanded their foreign operations. This latter development consisted more of shifting ever increasing chunks of deposits to the Euro-dollar market, where small banks competition was almost impossible and where, as is known, no reserve requirements apply.

The whole huge growth of these two markets, the C.D. market, and the Euro-dollar market, seems to have been caused by the peculiarities of U.S. banking legislation, which has been passed in the inter-war years and is aimed at favouring the financing of home-building, by forbidding the remuneration of deposits and by giving special privileges to thrift institutions which, in turn, financed home-building at fixed rates.

In addition, the American financial system's development in the last fifteen years has been profoundly affected by the transformation of the U.S. from a low-inflation economy into a high-inflation one. The new reality of permanent inflation has radically changed the way in which firms and individuals organize their financial transactions. High inflation rates bring in their wake high nominal interest rates. It becomes consequently impossible to ignore the cost of idle balances and of alternative liquidity sources. The coincident electronic revolution has rendered this transformation more hectic and radical. The gist of the change is that economic agents now view themselves as being at the same time borrowers and lenders. As Sir John Hicks had suggested fifty years ago[7)], all economic agents now have financial assets and financial liabilities. This applies to individuals as well as to business firms. Both categories borrow to finance purchases of everything except the most non-durable consumption goods and at the same time hold portfolios of interest-yielding financial assets. To exploit this new reality a myriad of new financial institutions have sprung up, especially because juridical impediments prevented banks from catering for the new needs of firms and individuals. The core of these new intermediaries' activity consists in giving their clients the possibility of maintaining liquidity and accessibility over their financial resources, invested in bonds, primary commodity speculation, common stock, etc. Having no reserve requirements to observe, these new intermediaries could perform the miracle of letting their clients have their cake and eat it.

All this was possible because of the "Common Law" approach, according to which "all that is not expressly forbidden, is permissible", while the "Roman Law" tradition is, as is known, rather the opposite, that is to say, that what is permissible is expressly identified by the written law. In the case of the U.S., the Common Law and Roman Law traditions have coalesced and this allows the cognoscenti to play a "hide and seek" game with the law keepers which is very profitable, as the sanction can apply to new realities only ex-nunc, and by that time the able are somewhere else trying a new trick. Most of what has lately gone under the name of "financial innovation" originates from this juridical peculiarity. And to this juridical approach and to the possibilities it opens to the clever operator, must be attributed the ever increasing meaninglessness of American money supply statistics, and the accompanying lore of money supply measures. Similarly, we can attribute to this juridical approach, and to the progress in electronic transactions, the increase in the velocity of circulation of bank deposits, with the accompanying problems of calculating interest accruals.

The state of flux in which financial transactions have lived in the U.S. in the past decade has been such that it has been authoritatively suggested that the "euthanasia of the saver" has been consummated and that we must now consider every financial agent as a "financial intermediary", accepting "in toto" Sir John Hicks' old suggestion. As a result, the most meaningful magnitude, for monetary policy, may be in the future, even the near future, of the U.S. financial system, the spread between banks' lending rates and the yield on financial assets. The whole community of citizens is thus seen as engaged in a continuous activity of financial arbitrage. In this new world, where liability management has spread from large banks to every individual, the chances that authorities have of controlling traditionally defined monetary aggregates are seriously diminished. Of course, if banks will no more be able to rely on stable deposits, largely interest-inelastic, banking will become a higher risk sector. This will increase the need for bank supervision and make higher capital requirements necessary for banks and other intermediaries.

How do other financial systems stand, vis-à-vis the revolutionary changes that are shaking the U.S. financial system so deeply? It must be said that the trend to make of every citizen a little financial firm cannot be resisted in any country where interest rates attain high nominal levels. This having been the case in most other Western countries, their respective financial systems have shown a much greater resistance to change than the American one. Generally speaking, one can say that the high degree of concentration that characterizes Western banking has favoured the development of banks into financial supermarkets, and prevented the rise of alternative financial intermediaries. Where those existed, as in England, the typical British solution has been found of letting the clearing banks buy them up and let them survive in a formal independence which may nevertheless have more than a modicum of substance. The development of a large international banking system, the Euro-dollar system, has, however, given large non-financial corporations a possibility to escape to some extent from the vice of national financial systems, thus increasing the discrimination that exists between large and small firms vis-à-vis national monetary policy. By and large, however, national financial systems, in the main Western countries, do not seem to have caught the financial fever that has shocked the United States. The reduction of inflation rates, of course, with the ensuing reduction in nominal interest rates, favours the resilience of financial systems to "innovation" of the type that has taken place in America. Another missing feature is the behaviour of the authorities who have, in the rest of the West, shown a much cooler disposition towards de-control. Even the ultra-laissez-faire British government does not seem to worry about concentration in English banking, and its free trading spirit does not seem to be hurt by the increasing banking supervision exercised by the Bank of England and by its rather heavy doses of "moral suasion".

It is time now, after the brief and rather summary review of financial developments in the main Western markets, to go back to the Italian scene, and to concentrate on the Italian financial system and on the policies adopted by Italian monetary authorities in the last decade.

The Italian financial system has been shaped around two primary needs: financing a State traditionally unable to fund its expenditures through taxation, and financing the investment expenditures of an industry grown more as an offshoot of the State than as the result of "development from below". In the economic history of modern Italy large industrial corporations were assisted, often even created, by large banks, founded with the help of the State following the French and German models. The idea of a money market separated from the capital market and from the Stock Exchange, remained, for the greater part of Italy's modern economic life, alive only in textbooks. What existed in reality was a financial structure based on the continuous intervention of the State, and thoroughly removed from the practice of competition. Of course, when world depressions came, as in 1907 and 1931, the collapse of large scale industry brought the financial system down, and the State had to intervene directly to rescue both.

After the crisis of the 1930s, the reconstruction of the financial system followed the French example. Large banks were directly taken over by the State, and Banking legislation was passed which was a strange mixture of Fascist corporatism and specialization principles. As was the case in the U.S., savings institutions were given preferential treatment and, again as in the U.S., the principle was established that banks could not hold the shares of industrial corporations. Special institutions were supposed to finance industrial fixed investment and banks had to confine themselves to short-term credit. The Stock Exchange was kept alive but it was not supposed to acquire a pivotal role in the financial system.

In the course of the late 1940s and the 50s, the Italian financial system did not develop any new features. The decadence of the corporatist State meant that monetary policy became almost exclusively delegated to the Central Bank. Industry did not require much fixed investment, so the supply of short-term credit through normal banking channels was sufficient. The inflationary episode of the early post-war period cancelled the real value of State and private debt. Governments showed a new preference for almost balanced budgets.

Under the surface, however, things were moving. The ruling Christian Democratic Party, which felt it did not control the financial system, traditionally the preserve of "lay" parties, began to favour through legislation and the practice of government, savings institutions, whose Directors were political appointees, to the detriment of large banks and especially of the Post Office Savings Bank, which had been established 50 years before on the French model and had grown to a very considerable size. The Savings Banks had smaller reserve requirements and an obvious competitive edge, as the Post Office Bank was ordered to limit its interest payments to a rate that made it uncompetitive with the Savings Banks.

Thus, in the 1950s, a new network of financial institutions was created. In addition to it, the Government favoured, in the next decades, the growth of People's Cooperative Banks, which in spite of their rather totalitarian name, were the expression of local industrial and commercial interests. A veritable plethora of those sprung up, together with small "rural banks" and "artisan banks". As a result of this trend, the Italian financial system looked, at the end of the 1970s, completely different from what it had looked in the early 1950s. The heavily dispersed plethora of small banks collected a very respectable chunk of deposits. Another large chunk was collected by "Public Law Banks", five large institutions whose directors are appointed by the Government or by local authorities. The traditional banking network had seen its share of the market considerably reduced, even if it was still responsable for much of the financial assistance to industry.

And so, from having been one of the most concentrated banking systems in Europe, the Italian became one of the least concentrated ones. In addition to the system's "balkanisation", the Government began to directly administer huge financial resources to industry and trade, through special programmes, aid to Southern industrialization, agricultural credit, export credit, etc.

Undoubtedly, a good part of the growth of small and highly local credit institutions can be attributed to the development of grassroot industrialization, which we have mentioned above.

But Italy's institutional framework is not a bit similar to the one where grassroot financial development can take place in a healthy and durable fashion. Financial institutions, be they large or small, cannot go bankrupt except in extreme cases. In most cases they are absorbed by other banks, if they find themselves in difficulty, and both workers and depositors are completely safeguarded. We seem to live in a fool's paradise where success is private and failure is public.

Moreover, while the Italian financial structure was being reshaped following the requirements of political parties and grass-root industrialists, Italy was becoming more and more integrated into the world economy. Italian banks were large participants in the Euro-dollar market. The trade to GNP ratio kept increasing and even very small Italian industrial producers became involved in foreign trade. In other words, while the integration process went on very rapidly, the Italian financial system became less and less comparable to that of other large European countries. We witnessed a contemporaneous move towards industrial liberalization and financial autarky, of which extremely severe foreign exchange control was an essential part.

To make things even more complex, the Italian economic authorities' reliance on monetary policy as the prime instrument of economic policy became even greater as time went by. And, starting in the mid sixties, the Italian government began to move from balanced budgets to massive deficit spending, thus following the generalised Western trend. Government debt began to grow rapidly and it first had to be sold to banks, then to the public.

Italian monetary policy has thus had to operate under very peculiar constraints. A high rate of real integration of the economy into the world economy, making for very large and wildly oscillating balance of payments financing requirements; an almost complete autarky of the financial system, whose degree of balkanisation has been increasing all the time; an almost completely interest inelastic large share of total credit, directly and indirectly administered by the State; the ever increasing Government deficit, with its counterpart of mounting Government debt. Finally, but most important, the continuous effort by the political system to penetrate credit institutions culminated at the beginning of the 1980s in an extremely violent attack on the independence and even on the personal liberty of central bankers, an episode which no self-esteeming Italian can recall without a feeling of personal humiliation.

To this list of constraints we can add the more general ones of Italy's participation in the EMS and of the escalation in world interest rates.

Small wonder, therefore, if Italian monetary policy has, in the whole post-war period and especially in the last decade, relied mainly on administrative measures, which have very little to do with free markets and freely formed prices. What Italian monetary policy has amounted to in recent years has been a rather rigid credit rationing system, closely supervised by the Central Bank, coupled with an almost complete internal inconvertibility of the Lira.

Of course, as in all cases of administrative control and rationing, black markets have sprung up, for foreign exchange as well as for credit. Their existence has managed to relieve to some extent the pressure on an economy as heavily integrated in the world economy as the Italian. The existence of black markets, however, saps in the long run the institutions of a civilized country, at their very roots, as the success of the law-breakers demoralizes the law-abiding citizens and the honest bureaucrats, and spreads corruption to every corner of the administrative institutions.

It is thus understandable that the Italian monetary authorities have made a timid and quickly reversed move towards a return to the market system. They have, in June 1983, abolished credit rationing ceilings, but have hastily informed the credit institutions about what levels of credit they want them to reach. They have thus tried to move from rationing to a free market, and ended up with "moral suasion".

Moral suasion is an old tradition of the Italian monetary authorities. Donato Menichella, who was Governor in the 1950s, publicly affirmed his reliance on telephone calls to commercial bankers, rather than on Discount rate changes. Italian bank supervision legislation, and the presence of a Branch of the Central Bank in every province of Italy, have given moral suasion increased strength.

But, as we noted above, the Italian financial system has become, in the last decades, much more balkanised and greatly more heterogeneous than it was when Menichella could make his confident statements. The recent humiliation of the Central Bank has certainly diminished its credibility vis-à-vis the more unruly and better politically protected sections of the banking community. The risk exists, therefore, that moral suasion will too often end up in confrontation, which would destroy the very meaning of the term. It is then almost inevitable that some sort of "corset" be again imposed on the banking system.

The Italian monetary authorities have made, in recent years, another attempt to move the financial system back to markets. This was when, approximately three years ago, the Central Bank announced that it would withdraw its support from the Government stock market. Government Debt would then be left free to find the price at which the market would absorb it. This measure, which brings the memory back to the end of the cheap money policies of Britain and the U.S. in the early fifties, has been and still is the subject of hot debates in Italy. Critics of the measure have advanced that letting the Government pay the full price of its financial profligacy is meaningless as the Government's demand for funds is almost completely interest-inelastic. Moreover, the withdrawal of Central Bank support usually means that lenders to the Government receive a more substantial reward for remaining liquid and this induces an upward shift of the whole term structure of interest rates, and a redistribution of income in favour of rentiers.

If we have to judge from the volume of Government debt issued before and after the Central Bank's withdrawal, it seems certain that the Government's profligacy does not seem to have decreased. The Central Bank may have kept its monetary base and money supply figures more tidy, but it is doubtful to everyone except the most naive monetarist that the impact of an extremely liquid public debt on inflation is smaller than that of the equivalent amount of money. In addition, we may recall Sargent's considerations on the inflationary impact of debt financing, as opposed to monetary financing. Finally, we may note that money creation means that somebody ends up holding the baby , while with an extremely short-lived, well remunerated, and therefore liquid, Public Debt, nobody pays the liquidity premium, thus nobody ends up "holding the baby". Since we have long ago been taught that there are no free lunches, this only means that the day of reckoning is shifted to the next period, or indefinitely if the mechanism is not modified, and that the account are squared via a rate of inflation higher than what it would be otherwise.

The Italian Central Bank has also, through the statements of its highest ranking officials, repeatedly expressed the desire to step back from active participation in the short-term management of the economy, to acquire a constitutional status of "warden of monetary stability" not unlike that accorded to the Deutsche Bundesbank by the Stability Act of 1966. This desire is understandable, especially in view of the dangers that a non-elected body encounters when making economic policy decisions that cannot put it above the fray. But the role to which the Italian Central Bank would like to see itself promoted would only be made possible by the passing of a Constitutional Bill similar to the German one we quoted. It is highly doubtful that a majority of two-thirds be found in Parliament for such a Law, which would put the Central Bank in a position as free as that of the Judiciary. An inflationary episode as traumatic as the pre-war German one would probably be necessary to convince public opinion that monetary stability is one of the prerequisites of a Democratic State.

Why did I give the present paper its title? The reasons should appear more clearly at this point. Italy, in the post-war decades, has experienced mutually conflicting trends in its industrial and financial structures, and monetary policy seems to be in a quandary, torn as it is between the constraints to which it is subjected both internally and externally and the desire of monetary authorities to remain, at the same time, in the group of "organisiert Kapitalismus" countries which form the EMS, and the wish to get out of trouble by "letting the market look after" the problems which the growth of grassroot industry, trade, and banking have created and the political system has consciously and unconsciously fostered.

It is only fair, at this point, that I jump off the fence and take sides. I stand firmly on the side of "organisiert Kapitalismus" as practised in France, Germany (and England before Thatcher) and as practised in Italy until the 1960s. It is highly probable that European countries will be extremely pleased to possess a system of institutional controls as they have developed when the excesses of the international financial market and the frightful oscillations of American economic leadership will finally induce a major crisis. Unfortunately, almost unconsciously but nevertheless very substantially, Italy has moved away from the fold of major European countries. To maximise output and employment in the short run, we have deeply transformed our industrial and financial structures. Our control mechanisms, fashioned after the European models, have become woefully inadequate to cope with the new reality. Every effort ought to be devoted, rather than to find radical solutions that remain only slogans, to reconstruct a network of controls adequate to the new reality.

FOOTNOTES

1. On the experience of vicious and virtuous circles, see M. de Cecco "Vicious and Virtuous Circles in the 1920s and the 1970s", in BNL Quarterly Review, September 1983.

2. Banca Commerciale Italiana, "Tendenze Reali", n. 22, January 1983.

3. On the EMS, the most up-to-date study available is H. Ungerer, "The EMS: the Experience 1979-1982", published by the IMF in May 1983.
The adjustment problems of small European countries, with vicious circles and the EMS are examined in M. de Cecco (ed.), "International asjustment, the EMS and small European countries", Blackwell, 1983.

4. On this subject, see A.O. Hirschman's brilliant essay "Rival interpretations of Market Society", in JEL, December 1982.

5. What I defined as "the Darwinian approach" to financial development, was made popular by Walther Bagehot. It has been recently proposed again by R.I. McKinnon in "Money and Capital in Economic Development", Washington, 1973, and by E.S. Shaw, in "Financial Deepening in Economic Development", New York, 1973.

6. The structural transformation of financial markets since the war has been recently analysed by C.A.E. Goodhart, whose excellent paper, "Structural Changes in the Banking System and the Determination of the Stock of Money", presented to the Conference on 'Western European Priorities', held in Brussels in December 1982, I have kept constantly in mind while writing the present essay.

7. "A suggestion for simplifying the theory of money", Economica, 1931.

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