Banca d’Italia Workshop
CENTRAL BANKING AND ITALIAN ECONOMIC HISTORY:
WHERE DO WE STAND AND WHERE ARE WE HEADING TO?
Rome, October 18, 2022

Session 2: “Central Banks and Major Shocks: What Do We Know from History?”

Stefano Battilossi

New research on central banks and global financial shocks under the Gold Standard

uc3m Universidad Carlos III de Madrid

Central banks and global financial cycle shocks

- Central banks acted as “absorbers” of Bank of England’s discount rate shocks (→ short-term capital flows) on domestic rate and exchange rate during the “mildly inflationary” Gold Standard (1891-1913) (Bazot et al 2022).

Balance-sheet “buffer” (Nurske-Bloomfield-Triffin) between the domestic economy and the global financial cycle:

-foreign assets (exchange market interventions + gold sales);

-domestic assets (sterilization)

Limited interest rate pass-through (0.24) (cf. 0.26 in Morys 2013)

Small and short-lived exchange rate depreciation

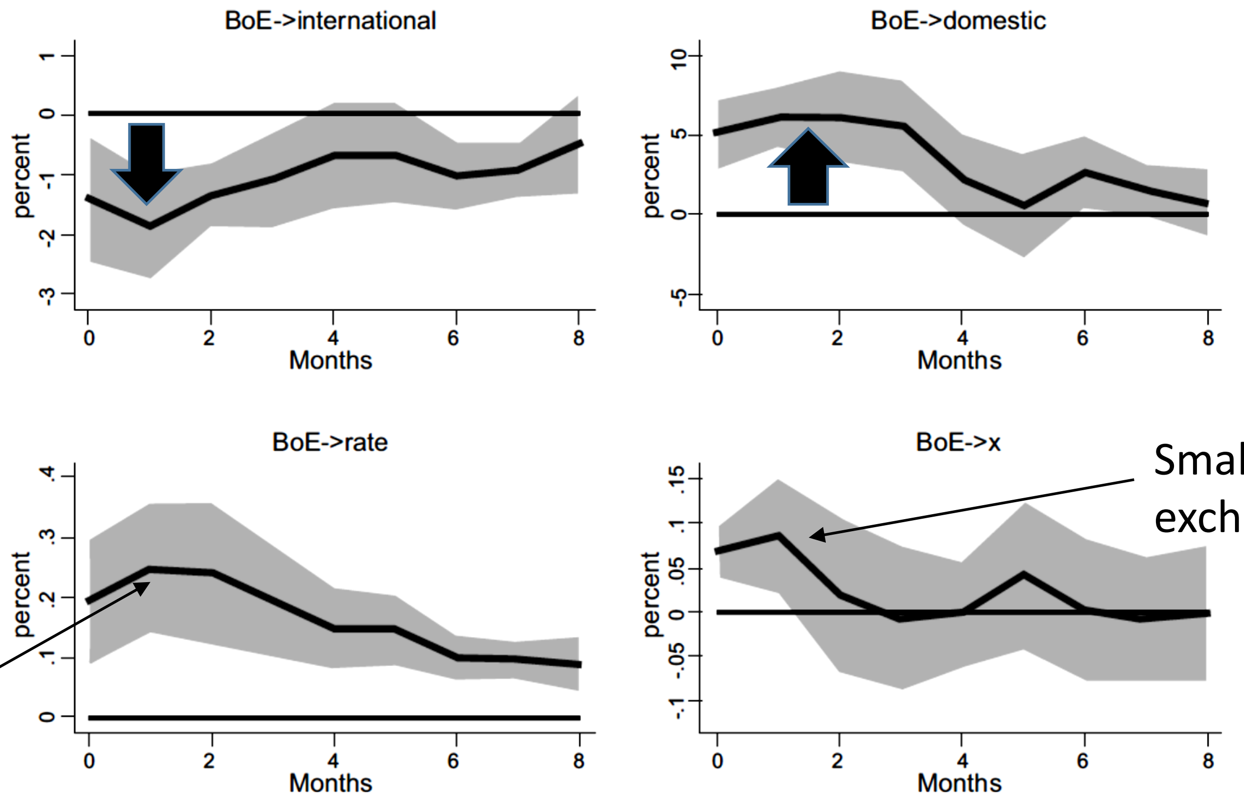


FIGURE 1
THE REACTION OF CENTRAL BANKS IN GOLD STANDARD CORE COUNTRIES
TO AN ENGLISH DISCOUNT RATE SHOCK OF 100 BASIS POINTS
IN THE FIRST EIGHT MONTHS

Central banks and global financial cycle shocks

- Gold Standard peripheries with lower financial integration and credibility: **Italy 1903-11 ("shadowing")**

Restrictions on convertibility

Slightly lower pass-through (0.17)

Expansion of credit to commercial banks (vs 5% in core)

Sharper and longer exchange rate depreciation (70% more than in core countries) → larger fluctuation band (Gold Points)

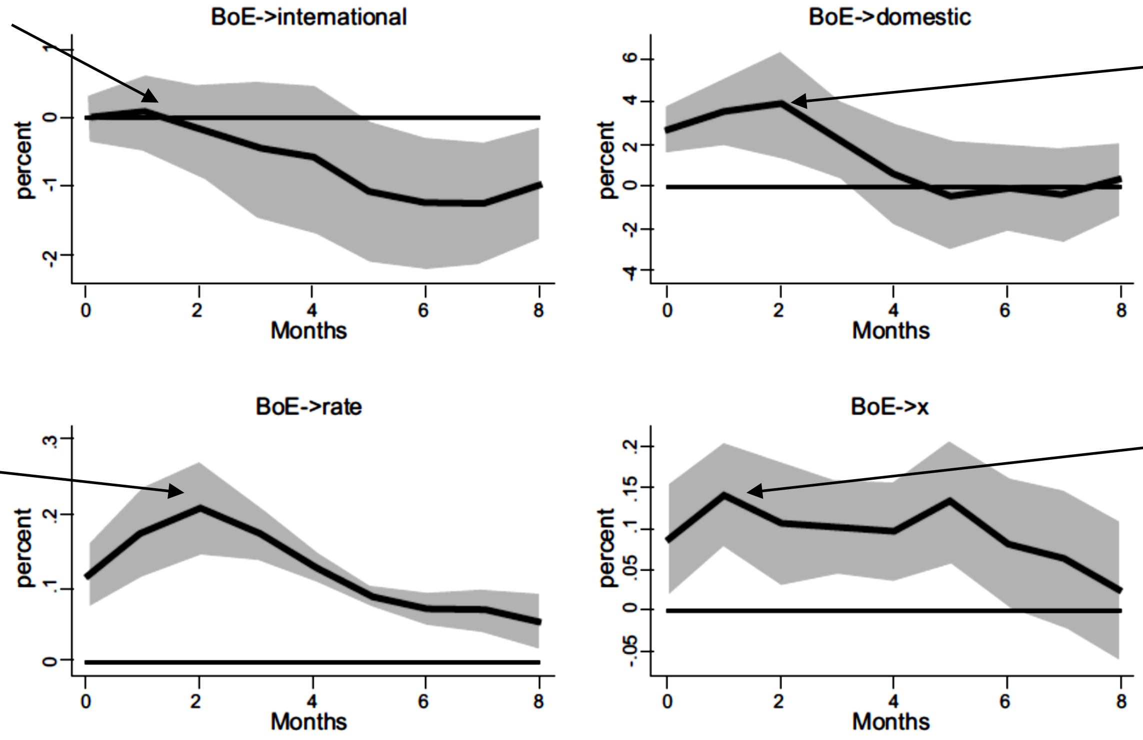
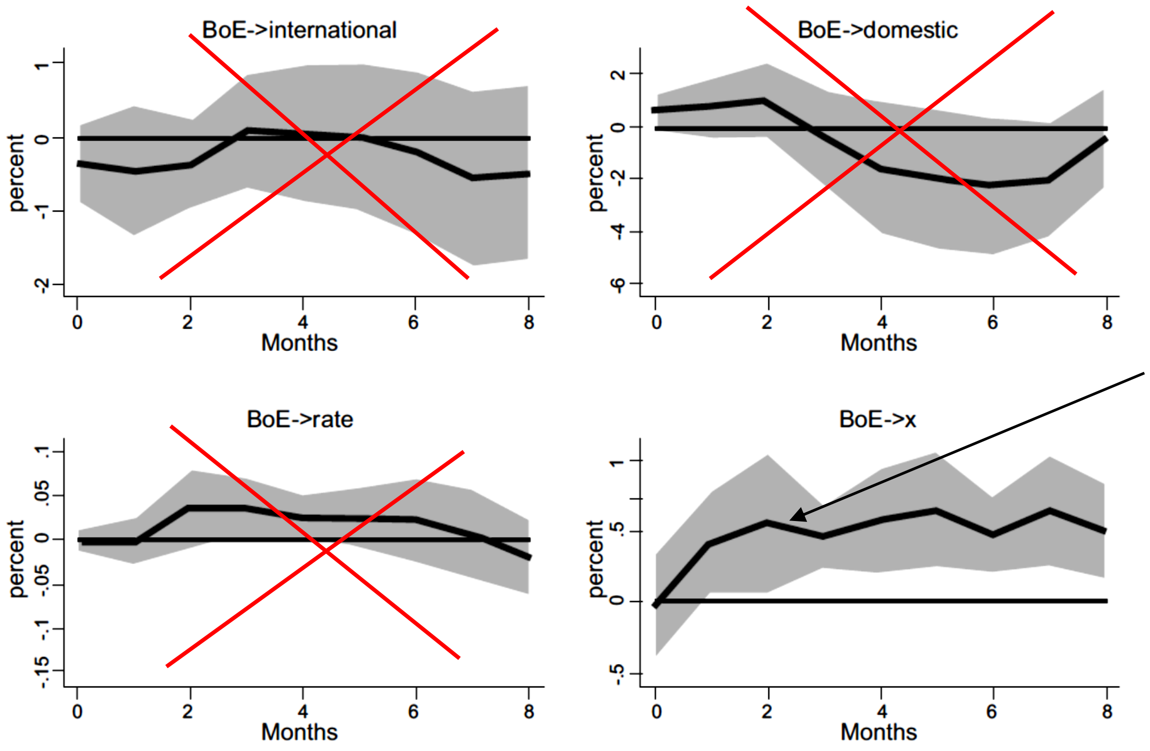


FIGURE 2
THE REACTION OF CENTRAL BANKS IN GOLD STANDARD PERIPHERAL COUNTRIES TO AN ENGLISH DISCOUNT RATE SHOCK OF 100 BASIS POINTS IN THE FIRST EIGHT MONTHS

Central banks and global financial cycle shocks

- Countries with fiat standards and floating exchange rates: **Italy 1887(1893?)-1902, 1912-13.**

Zero pass-through:
a floating exchange rate
ensures isolation and
full monetary autonomy



The exchange rate absorbs entirely international shocks and depreciates more than in GS peripheries

FIGURE 3
THE REACTION OF CENTRAL BANKS IN FIAT STANDARD COUNTRIES
TO AN ENGLISH DISCOUNT RATE SHOCK OF 100 BASIS POINTS
IN THE FIRST EIGHT MONTHS

Central banks and global financial cycle shocks

USA 1891-1913

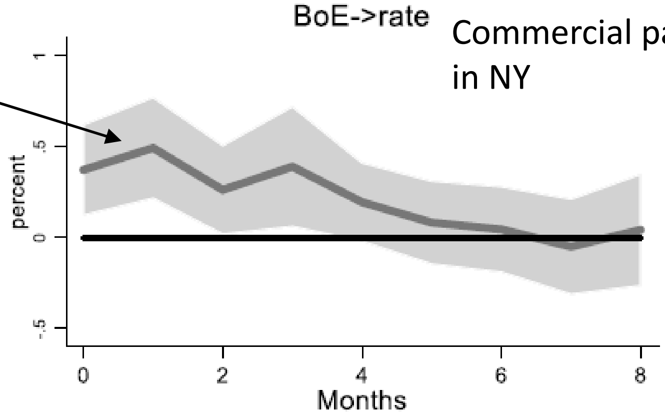
- Costs of not-having a central bank:

-higher interest rate pass-through (0.50) [close to 1 for alternative measure of BoE rate: Lennard 2018]

-the burden of the adjustment falls entirely on the money market

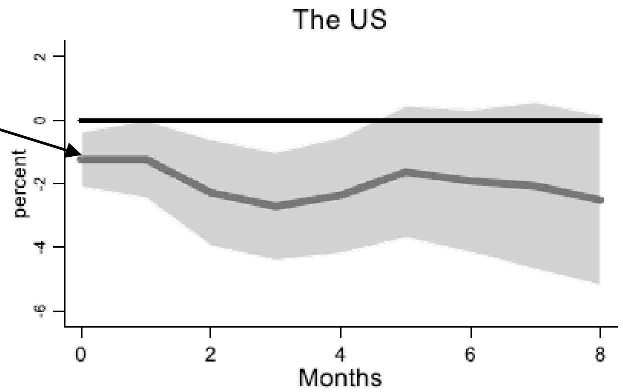
-heavier exposure of the real economy.

Much closer to the “trilemma”



Commercial paper in NY

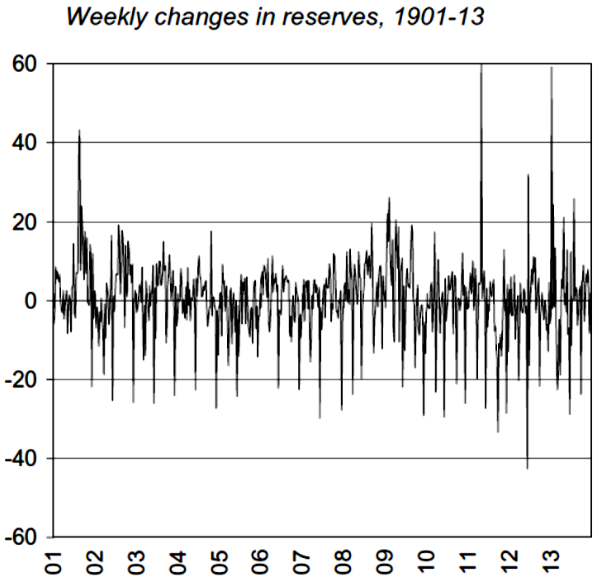
Strong and persistent negative effect on stock market (business cycle)



Central banks and global financial cycle shocks

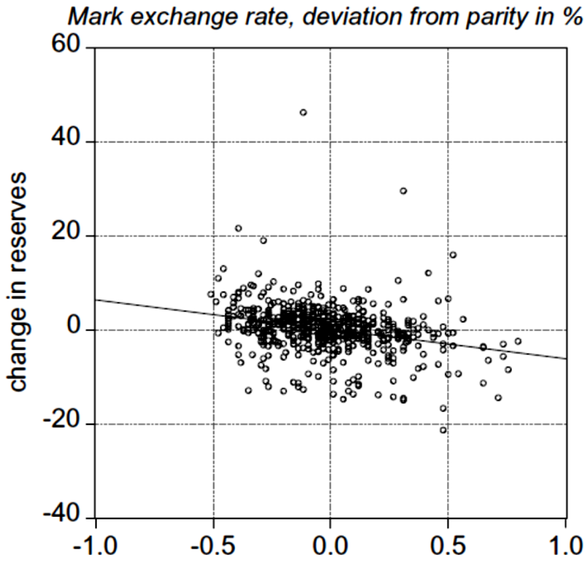
- Credibility (target zones: Flandreau and Komlos 2006) or foreign exchange interventions?

Highly sophisticated exchange market interventions of OeUB, including forward and repos. Central bank as market leader (centralization of foreign exchange reserves) (Jobst 2009)

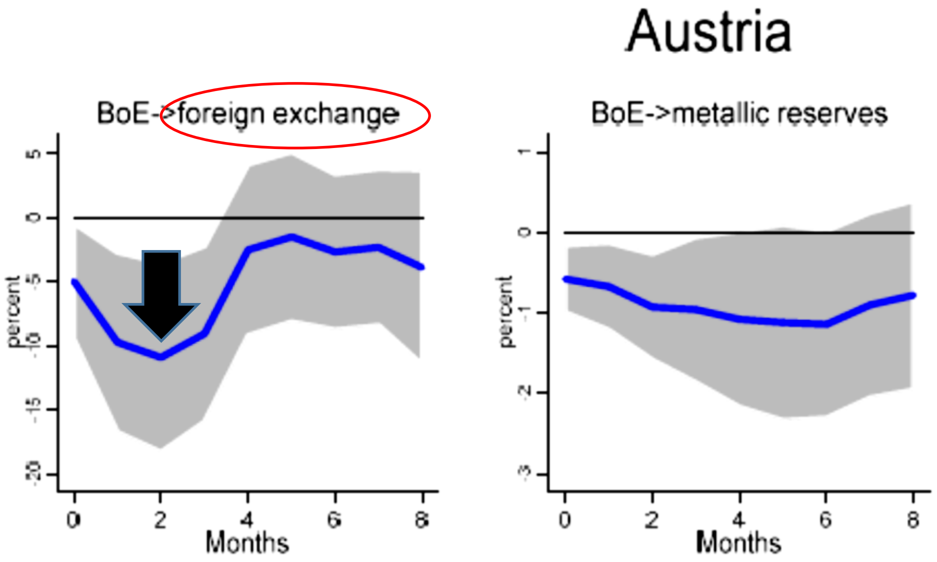


Plain vanilla interventions

Source: Jobst 2009



Weak linear relationship with the exchange rate: more discretion than pre-commitment



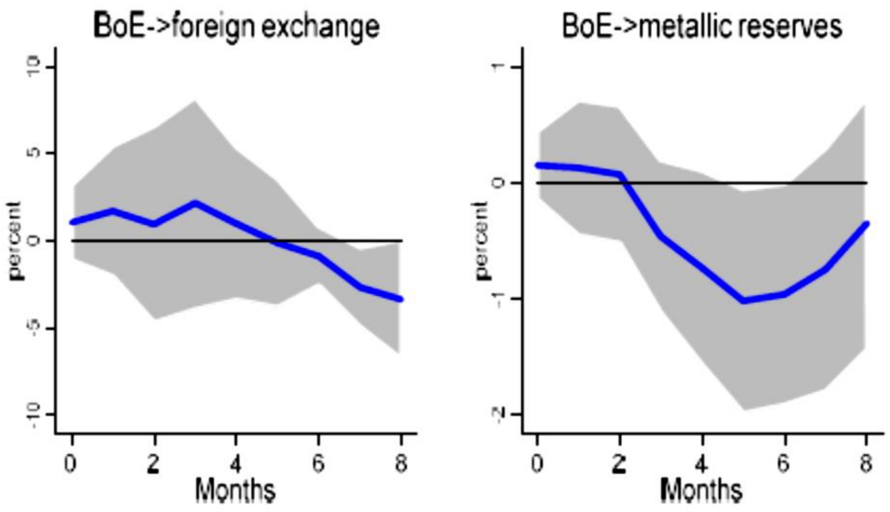
Source: Bazot et al 2022 Appendix

Central banks and global financial cycle shocks

- General pattern:

peripheries on gold did not use foreign exchange interventions to “tame the global financial cycle”.

Peripheral countries on a Gold Standard



Source: Bazot et al 2022 Appendix

Central banks and global financial cycle shocks

- How did Italian banks of issue “absorb” global shocks? (Di Martino 2022 and forthcoming)

  - Banca Nazionale ill-equipped due to scarcity of foreign assets (excluded from statutory reserves)

-October 1884 and April 1885 (BoE rate from 2 to 5%):

sales of foreign bills + short-term borrowing from correspondents (cheques payable in London and Paris) + gold sales to support Rendita in Paris (coupon payable in gold)

→ neither exchange rate stabilization (Lira above gold export point) nor insulation (discount rate up from 4 to 6%)

  - Learning: discount rate actions were useless and should be avoided (*Grillo to Luzzatti, 1889*)

Central banks and global financial cycle shocks

- Banca d’Italia: since 1893 foreign exchange included in statutory reserves + buffer of “free” reserves conceived as first line of defence (*Stringher to Luzzatti, 1906*).

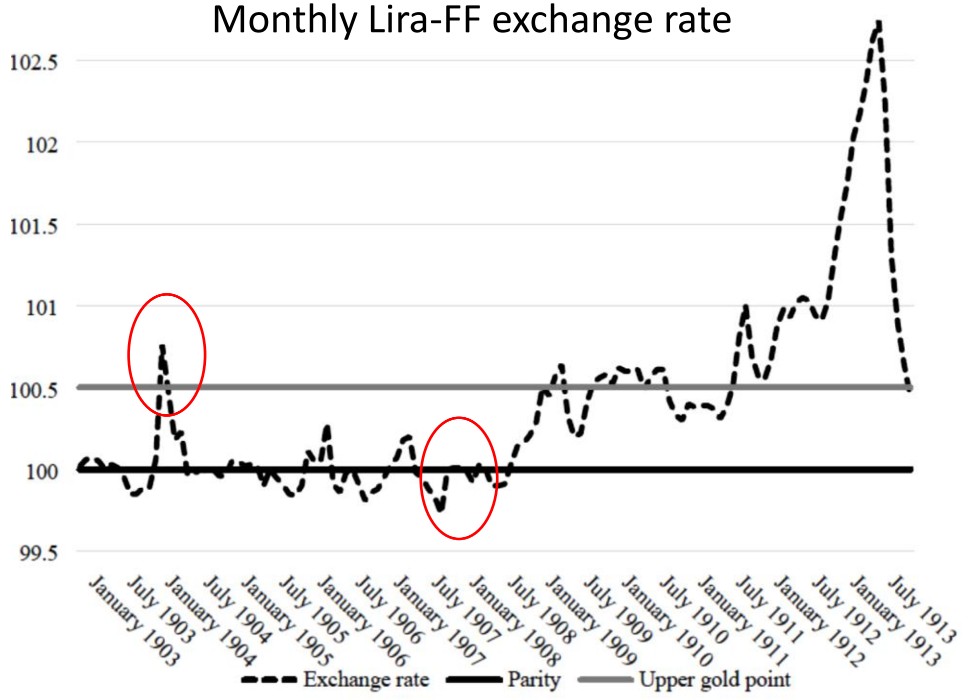
-January-February 1904: low level of forex reserves; sale of foreign bills (with Comit) but Treasury denied the use of gold reserves to support Rendita in Paris; interventions suspended; no official rate action

→ failed exchange rate stabilization (violation of gold export point)

-November-December 1907 (BoE rate up from 4.5 to 7%, RB 5.5 to 7.5%): high level of forex reserves but apparently no interventions; expansion of domestic credit (successful LLR to “absorb” domestic shock: Vercelli 2022; Toniolo 2022 ch 4.8) + expansion of metallic reserves (also through conversion of forex)

→ partial insulation (BdI average discount rate up from 4.5 to 5.5%) and perfect exchange rate stability (low country risk status: Toniolo 2022).

Monthly Lira-FF exchange rate



Source: Di Martino forthcoming

Central banks and global financial cycle shocks

- Italy was not an exception: central banks of European peripheries responded to episodes of acute financial strains and prolonged violations of gold export points by <u>reducing</u> their rate spread vis-à-vis core countries (Morys 2013).

- Proposed explanations:

- bank rate actions were considered ineffective

- with underdeveloped money markets, “moral suasion” was more effective in reducing demand for foreign currency.

	General discount rate spread to England and Germany (basis points)	Episode 3: crisis of 1907–1908 (American banking crisis) 27.10.1907–1.1.1908		
		Discount rate increase during crisis (%)	Maximum discount rate during crisis (%)	Discount rate spread to England and Germany (bp)
England		2.5	7.0	
Germany		2.0	7.5	
Sweden	94	1.0	7.0	−44
Norway	100	1.0	6.0	−120
Austria-Hungary	26	1.0	6.0	−123
Italy	22	n.a. 1.0	n.a. 5.5	n.a. -175
Romania	172	1.0	8.0	80
Average periphery	83	1.0	6.8	−52

Source: Morys 2013

No entries for Italy in episodes 1–3 as Italy was either not yet on gold or not in violation of the gold export point.

Central banks and global financial cycle shocks

Conclusion

- In general, new research provides compelling evidence that “Golden Fetters” were much less binding for domestic monetary conditions than usually assumed: central banks enjoyed significant “freedom to manoeuvre”

→ no sharp discontinuity in central banking between the classical (“stable”) and the interwar (“unstable”) Gold Exchange Standard

→ beyond empirically detectable common patterns, “each country’s record as a member of the gold club must be assessed not from the point of view of rules that never existed but from the point of view of each country’s needs, constraints and potentials” (Flandreau and James 2003); comparative analysis welcome!

- E.g. “flexibility-within-the rules” (i.e. informal controls on gold trade) allowed DNB to “navigate” a destabilized interwar GES and “go alone” (preserve autonomy) while remaining in the Gold Bloc after the “decoupling” of monetary policies since September 1931 (Fliers and Colvin 2022).

Central banks and global financial cycle shocks

References

- BAZOT G., MONNET E., MORYS M. (2022) “Taming the global financial cycle: central banks as shock absorbers in the first era of globalization” *Economic History Review* 82(3)
- DI MARTINO P. (2022) “At the heart of Fenoaltea’s Italy: Italy and the international financial market (1880-1913)” *Rivista di Storia Economica* 38 (2)
- DI MARTINO P. (forthcoming) “Central banks’ intervention in exchange rate markets during the international gold standard: Italy 1880-1913” *Financial History Review*
- FLANDREAU M. and JAMES H. (2003). Introduction. In M. FLANDREAU, C.-L. HOLTFRERICH and H. JAMES (eds), *International Financial History in the Twentieth Century. System and Anarchy* (Cambridge)
- FLANDREAU, M. and KOMLOS, J. (2006) “Target zones in history and theory: efficiency, credibility, and policy autonomy” *Journal of Monetary Economics* 53(8)
- FLIERS P. and COLVIN C. (2022) “Going Dutch: monetary policy in the Netherlands during the interwar gold standard, 1925–1936” *Financial History Review* 29 (2)
- JOBST C. (2009) “Market leader: the Austro-Hungarian Bank and the making of foreign exchange intervention, 1896–1913” *European Review of Economic History* 13
- LENNARD J. (2018) “Did Monetary Policy Matter? Narrative Evidence from the Classical Gold Standard.” *Explorations in Economic History* 68 (2018)
- MORYS M. (2013) “Discount rate policy under the Classical Gold Standard: Core versus periphery (1870s–1914)” *Explorations in Economic History* 50
- TONIOLO G. (2022) *Storia della Banca d’Italia*. Tomo I: *Formazione ed evoluzione di una banca centrale 1893-1943* (Bologna)
- VERCELLI F. (2022) “The Italian Banking System During the 1907 Financial Crisis and the Role of the Bank of Italy” Banca d’Italia Quaderni di Storia Economica n.49