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MONETARY POLICY IN A CHANGING WORLD ECONOMY

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I. Introduction

Monetary policy has undergone several important changes in recent decades in response to changes in the nature of the shocks affecting the world economy, new insights of economic theory and rapid innovations in financial markets.

In the fifties and early sixties there was a long period of smooth changes in financial markets with no major real disturbances. This was followed by a period of rapid change and turmoil. Successive periods of turbulence and tranquility are not new in the history of the world economy. The age of the gold standard and the early years of Bretton Woods shared many features -- no upheavals, a firmly-established international monetary order and fixed exchange rates -- and they were both followed by large real shocks, higher inflation and financial disorder.

The type of monetary policy pursued when financial change was slow and real economies were stable was not well suited to the subsequent periods of upheaval. As Ralph Hawtrey wrote in his celebrated book, "the art of central banking is a dynamic process placed at the core of the complex interactions between money, politics, and market forces".[1]

The two shocks that most affected industrial economies in the last twenty odd years were the oil-price hikes of 1973-74 and 1979-80. Several European countries were also hit by a wage explosion between 1968 and 1973, while the gradual increase in the taxation of labour income may have affected the supply side of some European economies by negatively affecting saving and investment. These events, coupled with the March 1973 switch to floating exchange rates and the greater monetary autonomy this gave the larger industrial countries, led to monetary aggregates being widely adopted as intermediate targets of monetary policy.

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1. Ralph Hawtrey "The Art of Central Banking", 1932.

Two developments in monetary economics also exerted an important influence on the decision to adopt monetary aggregates as targets: the debate on rules versus discretion and the related developments in the theory of expectations. Friedman and Phelps had already argued in the late 1960s that rules were superior to discretion on the grounds that the lag with which information on the state of the economy becomes available is far from negligible, and that the lags affecting the implementation of policy and, in particular, the effects of fiscal and monetary policy on economic activity are long and variable. The theory of forward looking expectations added further support to rules and encouraged the abandonment of short-run stabilization policies. The argument runs like this: since economic policy changes can be anticipated by sophisticated financial markets, they will tend to influence prices rather than real economic activity. On the other hand, the announcement of monetary targets helps to stabilize price expectations and enhance the credibility of anti-inflationary policies.

Against this general background I shall examine the recent changes in the monetary policy environment and the way central bankers have tried to cope with them, starting at the global level, and then looking more closely at the situation in Europe.

II. Monetary policy in the largest industrial countries

The distinguishing feature of monetary policy until the mid-seventies was the emphasis on interest rates as intermediate targets and the virtual neglect of monetary aggregates. The latter began to be emphasized after 1974-75, although the transition was gradual since interest rates remained an important instrument of short-term monetary policy. This combination implied the accommodation, at least in the short run, of real disturbances, whether originating in the balance of payments, the

labour market or fiscal policy. Ex-post this proved to be incompatible with achievement of the pre-announced quantitative objectives and failed to ensure long-run price stability. The second oil shock of 1979 aggravated inflation and made a drastic change in monetary policy inevitable.

In October 1979 the US changed its monetary control procedures by replacing short-term interest rate pegging with the quantitative control of bank reserves. In Europe, the countries that set up the EMS in March 1979 and accepted its exchange rate discipline, effectively anchored their monetary policies to that of Germany, where the credibility of the central bank had remained unchallenged even after the switch to floating rates.

The shift to monetary targeting was not without its problems. The first being the definition of an aggregate that could be accurately targeted. Innovation increased both the liquidity of financial assets and their substitutability with monetary instruments. Furthermore, regulatory changes increased the supply of bank deposits offering a return. Finally, the sharp fall in interest rates after 1982 produced an unexpected rise in the demand for liquid assets. Consequently, monetary policy was unable to prevent the overshooting of pre-announced targets, and central bank credibility suffered. Especially in the US, the excessive importance market participants gave to money supply statistics intensified short-run speculative activity that aggravated perverse short-term movements and price volatility.

The second problem with monetary targeting was caused by central banks' desire to prevent wide fluctuations in exchange rates as a result of the increase in capital mobility stemming from the progressive removal of capital controls, advances in information technology and lower transaction costs in international financial markets. Large capital inflows tended to undermine the credibility of monetary targets by causing substantial overshooting. The third problem lay in the greater

international substitutability of monetary and financial assets, which tended to make the demand for money more unstable.

Finally, in the eighties monetary policy has been overloaded with objectives: the control not only of inflation and aggregate demand but sometimes also of the exchange rate. Other policy instruments, in particular fiscal policy, were increasingly used to promote medium-term supply side improvements. Notably, this approach was adopted in the United States, the United Kingdom and Canada, leading to higher real interest rates, exchange rate pressure and large international payments imbalances. By contrast, in continental Europe and in Japan fiscal policy was used primarily to stabilize the public debt.

In 1985 growing international payments imbalances, coupled with serious exchange rate misalignments, forced the major countries to acknowledge the unsustainability of their fiscal-monetary policy mixes and to seek greater monetary policy coordination, while also recognizing that some fiscal policy coordination would certainly not have hurt.

In this respect the 1980s can be divided into two periods: the first marked by an unsustainable US fiscal-monetary policy mix and neglect of the dollar; the second marked by a new US attitude towards the dollar following the Agreement reached at the Plaza in September 1985. On several occasions in this second period national monetary policies have been formulated with the aim of stabilizing exchange rates around agreed levels, judged to be in line with economic fundamentals. As confidence in the stability of money demand has waned, the exchange rate has gained in importance as an indicator of the overall easiness or tightness of monetary policy. In addition, more emphasis has come to be put on interest rates, not only as short-term instruments of monetary control, but also as a means of signalling the authorities' policy stance to market participants.

During this period, the US government has also officially recognized that its fiscal policy influences both interest rates and the dollar. The importance of this change in attitude is clearly revealed in connection with the axiom that highly open economies cannot simultaneously have capital mobility, stable exchange rates, an independent monetary policy and a fiscal policy aimed exclusively at domestic objectives. A better balance had to be found between these four conditions. The integration achieved in national financial markets was considered an important step forward and liberalization of capital movements was regarded as irreversible. Since monetary policy alone could not both curb inflation and stabilize exchange rates, fiscal policy, which had had a purely domestic orientation until then, was required to contribute more to external adjustment. In other words, after the Plaza Agreement exchange rate stability was reinserted as an economic policy objective, and shortly after fiscal policy was included among the instruments of external adjustment. However, the actual extent of US-German coordination in this field has so far been less than expected.

Are we to conclude that experience with monetary targeting has been negative? I don't believe so. Targeting played an important role in fostering disinflation and not only led central banks to announce their policy stances but also forced them to explain deviations. Announced targets were a sign of the monetary authorities' commitment to stick to their policy course. In this respect quantitative targets continue to be valuable as a means of signalling the authorities' orientation and of anchoring private agents' expectations. Bank of Italy practice is to set targets consistently with a broad official macroeconomic and financial scenario prepared on the basis of both judgemental and econometric inputs.

It can perhaps be argued that during the 1980s some monetary authorities have been excessively tolerant of large deviations of monetary aggregates from their targets, whether due

to the instability of the demand for money or other factors. This may indeed be true, and this tolerance may have contributed, through an excessive accumulation of money balances, to the recent worldwide acceleration of aggregate demand and inflation. We should not forget, however, that an overly rigid monetary rule is unlikely to be optimal. Central banks usually have to strike a difficult balance between opposite risks, based on incomplete information and interpreting the signals provided by several economic variables.

The exchange rate and primary product prices are, I believe, good early indicators of inflationary pressure. The advantage of the exchange rate as a target is that it has a greater "political force" compared with other targets, since its importance is easily appreciated by the general public. Unfortunately, of course, it cannot be a target for the world economy: the major countries have to provide the nominal anchor for the others.

III. Monetary policy in the EMS

The problems encountered by monetary targeting are also found in the Exchange Rate Mechanism of the EMS. The monetary authorities of the member countries have to grapple with unstable demand for money and currency substitution, as well as over- and undershooting of monetary targets due to large capital flows. They also need a price anchor for the system and additional indicators of monetary conditions. Finally, they are faced with monetary policy being overburdened with too many objectives.

To help explain the changes set in motion by the 1985 Plaza Agreement, I referred to the impossibility of simultaneously having capital mobility, exchange rate stability, an independent monetary policy and a domestically-oriented fiscal policy. At the level of the ERM these four conditions constrain the authorities

of the member countries rather differently. The importance given to stable exchange rates is much greater than at the world level, witness the formal exchange rate arrangement and joint realignment decisions. So far capital mobility has been less important, but this is changing rapidly as 1990 approaches. Willingness to coordinate monetary policy has also been greater, though capital controls made such action less urgent. In fiscal policy coordination, the ERM is as far behind as the rest of the world.

The ERM is nonetheless undergoing a dramatic transformation in response to the two major changes in the setting of monetary policy: growing freedom of capital movements and of establishment of banking and insurance firms in all member countries. Since greater capital mobility and exchange rate stability are irreversible choices, they will come to impose a tighter constraint on the monetary policies of the ERM countries.

Governments and central bankers are aware of this tighter external constraint on monetary policy and of the potential consequences of increased capital mobility, especially when markets expect realignments. They are nonetheless confident that they can cope with the challenge and consider the present scepticism of some academic economists somewhat exaggerated.

Awareness of the implications of the reduction in monetary policy independence has already led to the reinforcement of the ERM embodied in the September 1987 Basle-Nyborg Agreement. It is also stimulating the debate on the development of a framework for closer monetary coordination, which in turn is giving new impetus to the idea of monetary union.

By granting access to the very short-term financing facility of the EMS for intramarginal interventions, the Basle-Nyborg Agreement increased the system's symmetry, since monetary conditions are affected in both the strong and the weak currency country in the event of a speculative attack. This

implies that interest rates will tend to move in opposite directions in the money markets of the countries involved, provided central banks do not fully sterilize the monetary base effects of their exchange market intervention.

Although the Basle-Nyborg Agreement is a step in the direction of closer monetary cooperation, a coherent framework for monetary coordination within the EMS is still lacking. The unresolved issues include a more explicit agreement than the present one on what should be considered the inflation anchor of the system. Such an anchor is crucial in every monetary system worthy of this name. Under the gold standard it was provided by the convertibility of notes into gold, and under the Bretton Woods system by the willingness of the United States to convert central banks' dollar holdings into gold. In the EMS the implicit anchor has so far been provided implicitly by German monetary policy and its strict anti-inflation stance. The special role of Germany in the system has led, however, to asymmetries in balance-of-payments adjustment that were acceptable as long as inflation differentials were high, but which need to be attenuated now that inflation differentials are smaller and declining.

One way to achieve closer and more symmetrical monetary cooperation would be to target the domestic component of the monetary base rather than the aggregate money stock. This would imply changes in international reserves being left unsterilized and interest rates moving in opposite directions in the face of symmetrical shocks. Some room for flexibility should in any case be provided for dealing with extreme cases of money demand or multiplier instability, currency substitution, and the like. Such flexibility is, of course, doubly necessary when responding to serious financial crises, such as the 1987 stock market crash.

IV. The need for fiscal coordination within the EMS and the debate on the inflation tax

Some observers are sceptical about the possibility of fiscal adjustment in "high" budget deficit/inflation countries. They fear that the fiscal policy coordination needed to maintain stable exchange rates will not be forthcoming. In their view, monetary policy will become a hostage to fiscal policy, with deficit governments ending up by having recourse to the inflation tax. This would make realignments necessary and prevent progress towards monetary union. In some respects this scepticism resembles that of many academic economists at the inception of the EMS. As then, there may be a tendency to underestimate the willingness of European governments to subordinate internal objectives to exchange rate stability.

The size and duration of the revenue from inflation should be a key factor. In Italy the government revenue from inflation was about 2.8 per cent of GDP in 1980, when inflation was over 20 per cent; it then fell steadily to about 0.2 per cent of GDP in 1987 when inflation was 4.7 per cent. Thus, the tax revenue that can be bought with higher inflation does not appear large enough for the inflation tax to be preferred to other explicit taxes. A number of other factors support this conclusion. Firstly, higher inflation may lead to a larger risk premium on government bonds, thereby offsetting most or all of the revenue from the inflation tax. Secondly, high inflation produces misleading price signals, resulting in the misallocation of resources. Thirdly, reducing inflation later is bound to entail high costs in terms of output and employment. Accordingly, the political cost of a higher inflation tax revenue may be substantially higher than that associated with more explicit taxation.

As I pointed out earlier, capital mobility and exchange rate stability will apply heavy, but healthy, pressure on countries with large fiscal deficits. This pressure should be allowed to produce its effects on fiscal authorities and help reduce the present overburdening of monetary policy within the EMS.

In conclusion the only politically and economically viable solution to the problem of some European countries' budget deficits is their significant reduction. Invoking alternatives such as the inflation tax and crawling pegs precisely when the political sphere is starting to come to terms with the need for fiscal adjustment is dangerous and could undermine the achievements of the last few years on the inflation front.

V. Conclusions

For a good part of this decade monetary policy has been in the forefront, bearing the weight first of the fight against inflation and then of exchange rate stabilization in an increasingly integrated and sophisticated financial environment. In many countries the impact of interest rate fluctuations on financial stability has also been a major concern. It is now increasingly clear that the attempt to pursue several, often conflicting objectives has resulted in an overburdening of monetary policy, and that the flexibility and effectiveness of global economic policy has suffered accordingly.

In addition, the increased sophistication of financial markets has also tended to reduce the effectiveness of monetary policy. Although these effects are hard to measure, it is probably true that larger changes in interest rates are now needed to achieve a given degree of stimulus or restraint. This is a disturbing development for monetary authorities, as it may make them more liable to misjudgements and overkills.

More actors will have to be present on the policy stage if we are to respond adequately to the increasingly complex needs of the international economy of the 1990s. Growth-oriented supply side policies have already gained ground in many countries. Increased flexibility and coherence of fiscal policies must be the next goal, both in the United States, where restraint is urgently needed, and in Europe, where some countries, including my own, still have to accept all the implications of the constraints that are implicit in the process of financial integration. Recourse to the inflation tax in deficit countries would certainly be a move in the wrong direction.