Mario Draghi: Reflections on monetary and financial policy – Governor Baffi's monetary policy

Address by Mr Mario Draghi, Governor of the Bank of Italy, at the Centro di Economia monetaria e finanziaria "Paolo Baffi", Università Commerciale Luigi Bocconi, Milan, 15 March 2007.

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The "Paolo Baffi" Centre for Monetary and Financial Economics has invited me to give this talk to revive the custom of the "Reflections on Monetary and Financial Policy" that had been interrupted for a decade. I thought it would be appropriate to start off the new series by exploring the personality and monetary policy of Paolo Baffi, to whom the centre is dedicated.

Baffi was Governor of the Bank of Italy during five of the most difficult years this country has known. It is not easy to discuss the problems that beset monetary policy in those years or the decisions that were taken using today's language. Since then, the conditions of Italy's economy and politics have changed radically, as have the prevailing opinions on the link between money and economy, the role of the central bank, and its objectives. The lexicon of monetary economics has mutated. The years in which Paolo Baffi was at the helm of the Bank of Italy, a period of exceptional economic and political difficulties, marked the start of the transition towards our present manner of interpreting and conducting monetary policy. Reviewing those years can help us recall the importance of institutional conquests that we now take for granted.

Intellectual roots and institutional framework

Paolo Baffi was one of the first professional economists to be taken on by the Bank of Italy; it was 1936. He took over the leadership of the Bank in August 1975, just a few days after Guido Carli's resignation, and was the first Governor to have made his career within the Bank.

Many of his writings bear witness to the intellectual evolution and choices of an economist whose outlook embraced equally theoretical interests and policy concerns. In 1935, after Italy invaded Ethiopia, Baffi's mentor, Giorgio Mortara, carried on a campaign against the international sanctions imposed against Italy from his *Giornale degli Economisti*. Baffi, twenty-four at the time, came out in favour of international economic cooperation, anxious about the nationalistic illusions entertained by his professor, who retorted with accusations of "internationalistic illusions".

The young man had obviously seen further ahead than the older one, who was soon to suffer the effects of nationalism transformed into anti-Semitism. What interests us here, however, is the fact that Baffi attributed his sound judgement at the time to a "diet of classical texts of economic liberalism".[1] This left an enduring mark on his training as an economist that was reflected in his subsequent theoretical output, less so in his policies, which were influenced by the formidable constraints existing during his time as Governor.

Economic liberalism, according to Luigi Einaudi, was not so much an economic doctrine as a way of reasoning, which takes an apparently simple rule and, through systematic use of theory, derives indirect and distant effects that are often the opposite of their proponents' intentions. Undoubtedly, one of the main characteristics of Baffi's thinking was his focus on indirect effects, on the links between the various elements of the economic system. His concern to make plain the relation between real and financial phenomena was at the root of the "national monetary balance sheet" developed in the aftermath of the War, the embryo of today's financial accounts.

In 1953 Baffi was a member of the committee appointed to pronounce on the reform of IRI's bylaws and its future role. While the majority of the committee favoured the creation of a Ministry for State Holding Companies and an increased role for IRI in promoting economic growth, Baffi and a few others held that the solution lay above all in sound regulation of the market.[2]

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1 P. Baffi, "Giorgio Mortara e la Banca d'Italia", in id., Nuovi studi sulla moneta (Milan: Giuffrè, 1973).

2 Ministero dell'Industria e del Commercio, L'Istituto per la ricostruzione industriale (Turin: Utet, 1955), Vol. II, pp. 575-85.

The 1960s and 1970s were, by admission of Baffi's predecessor, Governor Carli, the period when political power was most closely interwoven with monetary, financial and supervisory policy; it was also the most dangerous time for the repercussions on the performance of the economy, both then and later.[3] In the first half of the 1970s, and particularly between 1973 and 1976, a dense web of constraints and rules developed regarding banks' portfolios, subsidized credit, interest rates, and capital movements. Baffi never came out openly against this, but his scepticism, rooted in his reading of classical texts on economic liberalism, was no secret to anyone inside the Bank of Italy.

To understand the central bank's modus operandi in those years we must consider the powerful influence exerted by the predominant economic culture. It was not a market culture. Its influence, combined with vested interests, often directed economic policy towards solutions that did not follow the market. In Italy, Keynesianism only acquired a foothold in academia towards the middle of the 1960s and the version that gained credence among policy-makers had a distinctly more dirigiste flavour than that prevailing internationally: not only did economic policies to support demand earn plaudits from politicians and economists, but more generally, above and beyond the actual Keynesian propositions, they saw broad government intervention in economic activity, especially investment, as the means of perpetuating the growth of the 1950s.

Development, industrialization and social and distributive conflict were the issues that attracted the best minds and the vision of political leaders. What was asked of monetary policy was to produce growth, capital formation, the narrowing of the gap between Italy and its European partners, and balance-of-payments equilibrium. Price stability was a secondary concern. The autonomy of the central bank was not viewed as essential to stability. In Italy, interest focused on the real economy; the role of money, the causes and effects of inflation were not common subjects of inquiry. Baffi's studies on money thus constitute a notable exception.

The discussions that Franco Modigliani had in 1967 with the top management of the Bank of Italy during the development of the econometric model exemplify the difficulty of describing the problems of monetary policy at that time using today's language and criteria. In those meetings Governor Carli defined the Bank's main objective as that of fostering a sufficient level of income to allow investment that would close the distance between Italy and the other members of the European Economic Community.[4] The Governor mentioned price stability only as a subordinate aim, and it was interpreted, moreover, solely as alignment with the level of international prices, that is to say an objective for the defence of competitiveness. The pre-eminence of the objective of price stability did not have formal sanction; it was not shared by public opinion, nor was it comprehended in academic and political circles.

Monetary management was increasingly entrusted to administrative controls on credit, namely the ceiling on the growth in bank lending (introduced in 1973) and the requirement that banks invest a part of their portfolios in long-term fixed-income securities. Initially designed for allocative purposes and to support private investment, these instruments were almost immediately employed for macroeconomic purposes and to facilitate the financing of the Treasury. Effective in rapidly curbing aggregate demand, they continued to be used until the end of the 1980s in spite of their allocative cost and the fact that they soon came to be circumvented.

Treasury bills were the main instrument for financing the Treasury. At the auctions it was customary for the Bank of Italy to submit a bid guaranteeing that all the securities on offer would be taken up at the floor price. Since this was often set above the levels at which the market would have subscribed the whole quantity issued, this obliged the Bank to make systematic interventions and prevented control of liquidity creation. The interbank market was anaemic and inefficient.

Heads of Government and Treasury ministers listened to the Bank of Italy, but the Bank had very limited independence in using the instruments of monetary policy. The discount rate was fixed by the Treasury, albeit on the basis of a proposal from the Governor, and nearly every act of the Bank was formally subject to the Government's oversight. The prerequisites for autonomy of the central bank comparable to that enjoyed by today's European System of Central Banks were lacking.

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3 G. Carli, Intervista sul capitalismo italiano, edited by E. Scalari (Bari: Laterza, 1977), p. 42.

4 G.M. Rey and P. Peluffo, Dialogo tra un professore e la Banca d'Italia, Vallecchi, Florence, 1995, p. 54.

The transition towards a "monetary constitution"

In the summer of 1975, when Baffi succeeded Carli, the Italian economy had fallen into the deepest recession since the war, triggered by the oil shock and by the credit tightening that had been agreed with the International Monetary Fund in order to counter the imbalance in the external accounts, the upsurge of inflation and the depreciation of the lira.

The shock hit Italy at the height of an expansionary cycle, at a time of extreme weakness of economic policy management. Wages, rising at annual rates of more than 20 per cent, had lost any link with productivity. The devaluation-inflation spiral seemed untamable, not least because of the perverse system of indexation. The Treasury's deficits, pushed up by increases in public spending that were out of control, had exceeded values compatible with non-inflationary financing. The central bank, unheeded, watched from the sidelines.

In the international arena, the prevailing view of the role of monetary policy was changing. The Bundesbank had been announcing money supply targets since 1974, and the Federal Reserve, under Paul Volcker, would adopt quantitative monetary targets in 1979.

In the Concluding Remarks that he read on 31 May 1976, Baffi, recalling similar opinions of Einaudi and Carli at dramatic moments, observed that the severe limitations imposed by the institutional framework did not allow the Bank of Italy freedom of action. In times of financial imbalance and wage inflation, he stressed, "control of the money supply has to be abandoned in order to avoid, or at least postpone, worse evils".

However, Baffi did not give up pursuing the fundamental goal: moving Italy towards institutional arrangements in the field of monetary policy that would guarantee monetary stability over the longer run. This process would not actually get under way until the start of the 1980s, with the "divorce" between the Bank of Italy and the Treasury promoted by Treasury Minister Beniamino Andreatta and Governor Carlo Azeglio Ciampi. During the era in which he was governor, Baffi launched a "campaign of persuasion" directed at public opinion and the political forces. It was his conviction that monetary policy, in order to be successful, had to be backed by the consensus of all society on the objectives, including price stability. Italy was still far from such a situation. In Baffi's view, what prevailed in determining the decisions regarding the public finances and wage trends was an alliance between different political and social groups that fuelled inflation.

In the Governor's view the first requirement for a reform of the monetary constitution was that the principle of safeguarding monetary stability become the linchpin of monetary policy. However, he considered that an insurmountable obstacle to this was the absence within the Italian legal framework of a provision, such as that in Germany, expressly entrusting the central bank with the task of defending the currency. A systematic search was made for arguments in support of assigning the Bank autonomous responsibility for fixing and pursuing monetary base objectives: during internal meetings the possibility was repeatedly raised of calling on the Government to enter into commitments to this effect or of using suggestions of similar import put forward by international institutions such as the European Economic Community or the International Monetary Fund.

As one of Baffi's leading collaborators has recalled, he invited the Bank's legal experts to delve into every legal nook and cranny in search of the desired precept.[5] The absence of a well-defined institutional framework made it necessary to adopt complicated logical exercises to argue in favour of the defence of the currency: for Baffi the principle of "no taxation without representation", violated by inflation insofar as it causes arbitrary redistribution, was the one to call upon to give the central bank the task of defending the currency.

In this "campaign of persuasion" Baffi frequently discussed monetary policy choices in the press. He believed that announcing monetary objectives was a factor of transparency that would have durably altered central banks' modus operandi. As he was to say later, "the actions of central banks are no longer cloaked in silence, and perhaps never will be again. Whereas in the past silence was seen as a guarantee of independence, today this is achieved by giving an explicit account of one's actions".[6]

[5] M. Sarcinelli, "Governor Baffi's monetary policy", Banca Nazionale del Lavoro, *Quarterly Review*, no. 179, December 1991, pp. 513-35.

[6] Banca d'Italia, *Annual Report for 1978*, p.158.

Baffi was strongly opposed to the tangle of credit and foreign exchange administrative controls through which monetary policy was conducted. He found it profoundly unsatisfactory "in having to direct central bank action in such a way that it suffocates a system that possesses its own valid parameters and mechanisms; in having to constrain the volume of credit potentially expressed by the flow of monetary base because it is not possible to regulate that flow; in having to channel the flow of credit". He was convinced that the costs of the distortions produced by administrative controls were substantial and lasting and that the monetary effects were ephemeral: in the long run the aggregates are brought "back into line with basic economic conditions".

Monetary management and the EMS negotiations

Baffi did not win the battle against the straitjacket that had been imposed on the market. The emergencies he had to tackle, the exceptionally difficult situation he faced with regard to taxes and wages forced him to continue to use the administrative constraints put in place by his predecessor in earlier years. Monetary policy itself was constrained by the fact that price stability was not explicitly targeted and by his belief that there was no consensus on this in Italy. He was convinced that a monetary rule, however necessary and well formulated, could not replace discipline in the decisions and conduct of society as a whole and that it had to follow, and not precede, the adoption of such discipline.

According to the expression used in the Concluding Remarks of the *Annual Report for 1975*, monetary management in those years was "coming to resemble an economy under siege". At the beginning of 1976, after political, business, trade union and academic pressure had led to an easing of liquidity conditions, the low level of the official reserves and the opening of a Government crisis triggered a violent attack against the lira, the presages of which had been underestimated up to the end of the previous year, and led to the closing of the foreign exchange market for forty days.

The turbulence on foreign exchange markets continued during the year with ups and downs and a succession of restrictive measures that included exchange and credit controls, the reintroduction of the ceiling on loans, an increase in compulsory reserves and rises in the discount rate for a total of nine points. These steps were effective in bringing the external balance back into equilibrium, replenishing the official reserves and repaying foreign loans. The exchange rate fell by about one third; inflation rose to 23 per cent and then slowed to about 12 per cent.

Recourse to administrative credit and foreign exchange measures was not avoided. Contemporary documents confirm that Baffi was against using administrative controls but also show that he was convinced their use could not be ruled out given the influence exerted by the state of the market.

Late in 1978, the dramatic year that saw the kidnapping and assassination of Aldo Moro and the killing of his escort, negotiations began for Italy's membership of the European exchange rate mechanism. Not a few considered acceptance of the external constraint as providing powerful support in curbing the factors – rents, wages and public expenditure – that prevented Italy from definitively overcoming an emergency that had lasted too long not to threaten the stability of the country's institutions.

Baffi's position was cautious: he recognized that belonging to the European Monetary System could help to bring down inflation, but he believed that this should be the result of agreement on domestic policies and that a start should be made before entering into the exchange rate commitment. During the negotiations Baffi advocated a system with a broad fluctuation band of 6 or 8 per cent about the central parity for all the participant countries. This idea was not disagreeable to the Bundesbank, which feared an inflexible exchange rate with partners marked by high inflation and low credibility. Baffi was well aware of the risks of a constraint associated with an exchange rate parity unrelated to the performance of the fundamentals of the economy. He feared that the results Italy had achieved in the three previous years in terms of replenishing the reserves and adjusting the current account of the balance of payments might be jeopardized by participation in a mechanism that would force the lira to appreciate in real terms, to the detriment of exports.

Italy did join the EMS, but with a broader fluctuation band than that applying to the rest of the System members. The exchange rate constraint helped to damp down inflation in the first half of the 1980s. Its symbolic value was perceived by the political and social forces as a prerequisite to Italian participation in European integration, and the Bank of Italy was able to implement counter-inflationary monetary policy. Baffi's caution with regard to the cogency of the exchange rate constraint may have proved excessive, perhaps, but only because System realignments were much more frequent than could have been predicted when the Exchange Rate Mechanism was agreed. At the same time, the availability of the broad fluctuation band, which he had argued for, allowed a degree of freedom for monetary policy and thus limited the risk of the speculative attacks that typify fixed exchange rate regimes. In Baffi's own words, the mechanism permitted "a soft transition, without the jumps, the discontinuities in market rates that trigger destabilizing speculation and often enable it to reap enormous profits".[7]

The legacy of Paolo Baffi

This is not the proper place to recount the well-known judicial affairs that forced Paolo Baffi to resign as Governor on 20 September 1979, only to be totally exonerated from the charges two years later. As he later said, his incrimination obliged him to contend "for two years and more not with bad money but with a justice system that was even worse". Quite apart from the machinations behind the scenes in his indictment, which had major repercussions on the Bank of Italy, it must be admitted that the institutional architecture of the day – the Director General's responsibilities included banking supervision but he was also a member of the Board of Directors of IMI – was a weakness, which was later rectified.

If the results achieved in the battle against inflation were only partial during Baffi's governorship, the successes that came in the course of the 1980s and 1990s can be traced to the seeds he had sown with his commitment to a new monetary constitution. During his Governorship the question of separating the responsibilities of government and central bank was posed. The process subsequently set in motion produced first the abandonment and then the prohibition of monetary financing of the Treasury, the assignment to the Bank of Italy of the power to set the discount rate, formal recognition of its independence and, finally, its formal mandate, within the framework of the European System of Central Banks, to work for the objective of price stability. The full achievement of independence nevertheless took another fifteen years, major legislative reform and, lastly, an international treaty.

In the 1980s and early 1990s, in a course of reform that was initiated and spurred in part by the Bank of Italy, broader and more efficient money and government securities markets were created. The effectiveness of indirect instruments of monetary control increased.

Paolo Baffi as Governor is perhaps best symbolically portrayed as a ferryman of ideas, with all the exertion that such an image implies. His intellectual heritage was liberal, embracing more leavenings of modernity than were to be found in the political and economic culture of the day. But action was fettered by the harshness of the times. These were years, let us not forget, of bitter social conflict, years of terrorism. Paolo Baffi's awareness of the drama of social problems was painfully acute, as is well known by those who were close to him in those years and could see the signs that a man of his temperament allowed to emerge.

Subsequent developments in Italy and in Europe and the consequent advances in economic theory have confirmed that the effectiveness of monetary policy depends above all on appropriate institutional arrangements and on the ability to affect the expectations and the behaviour of the public; and that appropriate institutional arrangements, in turn, are not unrelated to political and social consensus. Institutions comprise the set of written and unwritten rules that guide the conduct of the central bank, formal recognition of its objectives and independence, and suitably designed instruments, ensuring effectiveness of action without interfering in the operation of a market economy.

To us Paolo Baffi, who was the very antithesis of the politician, has bequeathed the conviction that the strength of economic policy springs from rigorous conduct and from the consensus it enjoys in the society within which it works its effects.

[7] P. Baffi, "Due momenti del negoziato sullo SME: la banda larga e l'adesione del Regno Unito" in *Il sistema monetario europeo a dieci anni dal suo atto costitutivo: risultati e prospettive,* Atti del convegno promosso dal Ministero degli Affari esteri e dall'IMI (Proceedings of a conference organized by the Italian Ministry of Foreign Affairs and IMI), Rome, December 1988.