Monetary Policy in Pre-ECB Italy

Leonardo Bartolini

Vice President, Federal Reserve Bank of New York.
leo.bartolini@ny.frb.org

In 1979, Italy entered into the Exchange Rate Mechanism (ERM) as a founding member of the European Monetary System. After that date, the country's monetary policy was geared toward the maintenance of exchange rate stability against its ERM partners, despite a number of exchange parity realignments and with the exception of the period from September 1992 to November 1996.[1] The strength of the ERM commitment was not uniform over time, either in terms of amplitude of the fluctuation band[2] or in terms of frequency of realignment of bilateral parities. Despite this variability, however, changes in official rates—the discount rate and the rate on fixed term advances—were overwhelmingly linked throughout the ERM period to developments in foreign exchange markets.

The broad exchange-rate stability objective was made operational as a target range for the overnight interbank deposit rate. This target was articulated as a corridor (in the 1990s, of typical width between 1 and 1.5 percent) effectively determined by the rates applied on Bank of Italy lender-of-last-resort operations: the discount rate (at the lower edge) and the rate on fixed-term advances (at the upper edge);[3] and by the market-determined tender rate on repos, the main tool used by the Bank to conduct its open market intervention, which steered the interbank rate within the corridor.

Besides entry in the ERM, the year 1979 also witnessed a formal shift in the broad goals of central bank intervention. Until that year, Bank of Italy intervention had been mostly intended to sustain the financing of the public deficit, by means of its purchases of securities directly from the Treasury. By contrast, in 1979 the goal of intervention was identified as controlling the liquidity of the money market. Also, in 1981 the Bank was granted formal independence in the pursuit of this aim, when its obligation to acquire all Treasury securities unsold to the public at primary auctions was rescinded. However, despite these changes, the Bank of Italy's ability to control the monetary base and set short-term interest rates remained constrained by a number of institutional arrangements, including the obligation it had to finance the Treasury through an overdraft facility covering 14 percent of annual expenditures. Furthermore, the power to modify the discount rate was, until February 1992, assigned by law to the Treasury, which acted upon proposal of the Bank of Italy. In effect, the main step in the granting of independence to the Bank was not completed until January 1, 1994, when Article 104 of the Maastricht Treaty became operational: The Treasury's account at the Bank of Italy (*conto di tesoreria*) was reformed, with closure of Bank credit to the Treasury and placement of strict limits on minimum balances held by the Treasury in its account at the Bank.

Other than the release of operational independence to the Bank of Italy, there were limited notable changes in the Bank's operating environment in the course of the 1990s. Averaging of reserve requirements was introduced in 1990, accompanied by a rise in the fraction of free reserves for daily use by banks. Reserve requirements were repeatedly lowered in the course of the decade.[4] And, as discussed below, foreign exchange swaps were included in 1992, alongside standard repo operations, among the instruments for intervention by the Bank in the open market.

Lender-of-Last-Resort Facilities

The Bank of Italy has engaged in lender-of-last-resort operations (*rifinanziamento*) only with banks. Three basic facilities were in place for this purpose: ordinary advances and fixed-term advances (as standing facilities), and discounting. By the end of 1998, financing under the three facilities equaled 33 trillion lire (or 24 percent of the monetary base),[5] up from a more typical 21 trillion in 1997 (11 percent of the monetary base).

Standing Facilities

Ordinary advances (*anticipazioni ordinarie*) were a collateralized overdraft facility for commercial banks accorded automatically, but whose amount was limited. Technically, the loan's maturity was up to quarterly, although in practice, loans were renewed routinely. The discount rate was applied to this facility and was normally set below market rates. Beyond that, banks could borrow at a second facility fixed-term advances (*anticipazioni a scadenza fissa*), representing discretionary credit offered by the Bank of Italy, which has, on occasion, been rationed. The rate offered for fixed-term advances was harmonized across banks in May 1991 and was set at the discount rate plus a surcharge (the latter being between 1 and 1.5 percentage points in the 1990s, unless the facility was accessed after 4 p.m., in which case a penalty of 8 percentage points over the discount rate was assessed). The maturity of fixed-term advances ranged between 1 and 32 days.

Acceptable collateral for these facilities included a list of securities (*stanziabili*) including both government and government-guaranteed securities, and other claims such as *cartelle fondiarie*, securities issued by *istituti di credito fondiario* and other special credit institutions, securities in lire issued by international organizations, securities issued by domestic agencies explicitly admitted (state railway agency, public holding companies, and the like), and bank bonds. De facto, the Bank has accepted almost exclusively public sector securities, effectively eliminating any issue of portfolio risk management. The value of securities accepted as collateral was marked to market, discounted by 15 percent for Treasury securities and by 20 percent for other securities. When the gap between the value of collateral and credit fell below one-half the

[1] During this period, the lira was floating freely, and an eclectic approach to monetary policy was followed. Targets for monetary aggregates were announced, but changes in discount and repo rates were implemented in response to a variety of indicators of inflationary pressure.

[2] The lira was linked to a grid of bilateral bands of plus or minus 6 percent amplitude from March 1979 to January 1990, plus or minus 2.25 percent amplitude from 1990 to September 1993, and plus or minus 15 percent amplitude from November 1996 until December 1998.

[3] While the interest rate corridor was typically effective, market rates could occasionally fluctuate outside their corridor, particularly as a consequence of the rationing of fixed-term advances.

[4] In the most recent instance, required reserves fell by about 75 percent from 1997 to 1998, as Italy brought its system of reserve requirements toward the European Monetary Union standard.

[5] A large share of this amount was connected with the restructuring of banks in difficulty in that year.

prescribed margin, credit was reduced to reestablish initial conditions, or the bank was required to place new securities as collateral (failing which, the Bank of Italy could proceed with the sale of the collateral).

Discount Operations

The most venerable ingredient of Bank of Italy financing of the banking sector, discounting (*risconto*) has always played a negligible role in the Bank's activities, largely reflecting the greater administrative complexity with respect to advances. (Conceptually, the main difference between discount and ordinary advance was that the former was discretionary, while the latter was automatic; the main difference between discount and fixed-term advance was that the former was offered at a subsidy rate, while the latter was offered at a penalty rate.)

The Bank of Italy could offer credit to banks in exchange for discounted deposit of securities including Treasury securities, bank bonds (as long as quoted and widely traded), and a limited set of other claims, for example, agricultural bills of exchange (*cambiali agrarie*). For such claims, the constraint was that their maturity could not exceed four months, and that—except for Treasury securities—they had to be undersigned by at least two agents of known solvency. In practice, the amount of securities other than Treasury bills involved in discount operations has been negligible and has been limited, for many years, to *cambiali agrarie*, the discounting of which has not played a role in monetary management.

Open Market Operations

Open-market operations effectively began in Italy in 1979. Since then, they have normally been conducted by a combination of repos and reverse repos (*pronti contro termine*), implemented as variable-rate, discriminatory auctions open to banks and a few other nonbank primary Treasury dealers. Less frequently, the Bank of Italy has engaged in outright purchases and sales of Treasury securities. These were conducted in the screen-based market (*mercato telematico*, or MTS) for Treasury securities, which began to operate in 1988, or directly through the phone. The periodicity and maturity of these operations were not fixed; typically there have been one or two auctions per week, with repos' maturity typically ranging between 10 and 20 days. At the end of 1998, the Bank of Italy was holding under repo arrangement only 4 trillion lire (or 3 percent of the monetary base), against 120 trillion held outright (87 percent of the monetary base). The corresponding figures for the end of 1997 were 29 trillion (15 percent of the monetary base) and 152 trillion (77 percent of the monetary base).[6] Data on stocks, however, provide little indication of the importance of various instruments in managing liquidity. In 1998, for instance, repos destroyed 25 trillion lire of monetary base, offsetting creation of 26 trillion lire through outright purchases and sales. Lender-of-last resort operations were responsible for destroying only 1 trillion lire of monetary base.

Based on Article 41 of its statute, the Bank of Italy could conduct open market operations using as counterparts only securities issued or guaranteed by the government. In practice, the Bank has dealt only in Treasury securities for repos and outright operations. For the conduct of the latter, the Bank has generally found the MTS to operate smoothly, thanks to its high liquidity and the transparency secured by its screen-based nature. Only rarely, mostly in the 1995–97 period, has the Bank experienced difficulties. These occurred only on occasion of unusually large operations, and were viewed by Bank officials as reflecting technical problems of timing: The public seemed unwilling to commit securities whose coupon payment was falling before the maturity of the repos, presumably reflecting problems connected with the accounting and fiscal treatment of these operations. The sporadic nature of these episodes, however, caused them to be looked at without particular concern by Bank officials.

Beginning in October 1992, the range of Bank operations was expanded to include currency repos in deutsche marks and dollars to relieve the burden of traditional repos in the management of liquidity.[7] Ordinarily, the stock of currency repos was kept at a roughly constant volume and was routinely renewed at maturity. Tender procedures for these swaps were similar to those for repos, with auctions conducted roughly every week or two, and maturity ranging between one and three months. Foreign exchange (FX) swaps had been eliminated by the end of 1998, in preparation for the European Monetary Union (EMU). They stood at 14 trillion lire at the end of 1997 (7 per-

[6] Positive shares can add up to more than 100 percent, reflecting negative contributions from sectors such as the Treasury's payments account.

[7] However, after the ERM crisis of 1992 drained most of the Bank's official reserves, currency swaps were also used as a tool to supplement the Bank's foreign exchange reserve holdings.

cent of the monetary base), against a more typical 42 trillion lire at the end of 1995 (24 percent of the monetary base).

Other than the noted introduction of FX swaps, the Bank of Italy had given negligible consideration to altering the stock of admissible collateral for open market operations. This was the case despite the fact that some observers have noted that the Bank's practice of utilizing (virtually) only Treasury securities in its operations may have acted as an incentive for financial sector firms to hold these securities instead of corporate debt, the market for which remains to a large extent undeveloped in Italy.

Selected Fiscal Issues

Through the entire 1990s (and earlier) the country's fiscal situation was never such as to cause worries that the supply of outstanding public debt could become insufficient to accommodate smooth conduct of Bank of Italy operations. Through most of the pre-EMU period, the Government of Italy's gross debt had been high and rising, reaching a peak of 125 percent of GDP in 1994, with deficit/GDP ratios topping 10 percent through the early 1990s. Fiscal retrenchment in the run-up to EMU brought the ratio to GDP down to about 116 percent by the end of 1998.

At the end of 1998, almost all Treasury debt (92 percent) was issued domestically. Banks and money market funds held in their portfolios government securities for 371 trillion lire, against required reserves of 26 trillion, providing ample cushion for the conduct of Bank of Italy operations. (Figures for the end of 1997, more typical of the previous decade, were 355 trillion and 90 trillion lire, respectively, as reserve requirements were reduced dramatically in 1998.)

References

Bank for International Settlements. 1997. Conference Papers No. 3, "Implementation and Tactics for Monetary Policy," Basel: BIS (March).

Bank of Italy. 1999a. *Economic Bulletin*, no. 28, Rome (February).

____________. 1999b. "Abridged Report for the Year 1998. Ordinary General Meeting of Shareholders." Rome (May).

International Monetary Fund. 2001. "World Economic Outlook." Washington, DC: IMF (October).

Passacantando, Franco. 1996. "Building an Institutional Framework for Monetary Stability: The Case of Italy (1979–1994)." *BNL Quarterly Review* 49 (196) March: 83–132.