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The Appropriate Foreign Exchange Regime In Italy

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1. Introduction

The foreign exchange market is the largest market in the world where different currencies are displayed and traded. It is of great importance to know the fair value of the national currencies of the countries in relation to the others, as they subsequently modify the value of the investments of a state. Therefore, it is essential to have adequate cash flow management systems that will safeguard the purchasing power of the currency in use.

The exchange rate has a fundamental role in the international economy and its value has a power to influence the decisions and commercial strategies of different countries. The factors that determine the value of the exchange rate are varied and mostly the business relationship between the two countries. The choice of exchange rate regime depends on the economic and institutional characteristics of the country and there is no better choice in advance, valid in every situation

This paper will discuss about the Italian exchange rate system along time and will end up with an analysis of the current exchange situation in the country. In order to achieve a good understanding on the topic, this work will examine the political and economic changes that Italy has been through.

The first part of the work will introduce the Lira, the currency that Italy had for 141 years, from 1862 up to 2002, when Italy joined the European Monetary Union and started using Euro as its new currency. In this chapter, the different kind of policies that the Lira had to hold will be depicted and different stages in the history of the Lira will be contextualized with its respective historical events. The second part will talk about the Italian exchange rate situation according to the entrance of the country in the European Monetary Union; that is from 2002 up to nowadays.

As a final chapter of conclusions, the macroeconomic effects of the current rate exchange policies will be listed and explained.

2. The Birth Of Lira

On 24 August 1862 Vittorio Emanuele II, king of Italy, filed the law of unification of the monetary system. The Italian lira replaced the previous coins and began its history, which would last until the introduction of the euro.

The conversion operations of the old coins went on pretty much smoothly on the Northern and Central part of the country, and towards the end of the 1865 could be said to have been concluded. Instead it was pretty slow process in the southern provinces, both for the amount of coins to be withdrawn (equal to 60 percent of the total), and for the underestimation of the constraints from the government.

At the beginning of the 17th century the states of the Italian peninsula were still among the richest in the world. Three generations later Italy was a country underdeveloped, predominantly agricultural, importer of artifacts and exporter of agricultural products. In 1820 the production per inhabitant was still stationary at level of two centuries before. In 1861 the average consumption of an Italian, according to the current purchasing power, was around 1,120 euros per year. At the celebration of the first fiftieth anniversary of the Unity, in 1911, the average Italian consumption had risen to 1,700 euro a year, with an increase of over 50 percent. In 1872 Italians had a life expectancy at birth of about 30 years (one of the lowest in Europe), while at the beginning of the First World War an Italian newborn had a lifetime expecatncy of 50 years. Today the Italians have a life expectancy among the highest in the world.

3. The First Exchange Rate Systems

In 1821 the Pound fixed convertibility was established with gold, and it passed from bimetallism to gold monometallism, so since that year only gold, and not silver, enjoyed unlimited power of liberation and could be used in any transaction. Great Britain had thus officially adopted the gold standard. The gold standard over time was gradually adopted by almost all countries. Once all countries had adopted this system, it was as if there was a currency stability between the currencies of the various states, in practice it was as if a fixed exchange rate system was in place, as all currencies were fixedly tied to gold. This fixed exchange rate system went down with the outbreak of World War I, and then resumed with the Genoa Conference of 1922. Here it was decided to adopt a gold exchange standard, or a system in which banknotes could be changed only with gold but also with other foreign currencies, which in turn are convertible into gold. This system was also destined to end very early, in fact, as a result of the great 1929 crisis, many countries began to devalue their currencies to have competitive advantages in international markets. The effect was the dissolution of the gold exchange standard, as the exchange rates between the currencies were not maintained. The currencies will thus be allowed to fluctuate freely until the end of World War II, when the Bretton Woods agreements will be concluded.

Shortly before the end of the Second World War, in July 1944, representatives of the allied countries, considering the victory of the war, met in New Hampshire to sanction the new agreements that would regulate trade and financial relations between the countries after the war. Those who went to history as the Bretton Woods agreements set a return to a monetary system based on fixed exchange rates. The US dollar would be the only currency convertible in gold, and all other currencies could be converted into dollars. Then a standard gold exchange was born. Among the most important consequences that came from Bretton Woods was the return to fixed exchange rates. Each country had to declare its currency equality with gold. In this way it was possible to define the exchange rates between the different currencies having the gold as a reference meter. The various currencies could have a maximum variation of + 1% / -1%, and the various national central banks had the task of enforcing the above limits, avoiding that the local currency would be devalued or revalued beyond the margins mentioned above.

4. Italian Monetary Policies And Their Effects On The Balance Of Payments

After the Second World War, the Italian monetary policy in the period from 1950 to 1969 achieved the goal of obtaining almost absolute price stability and finally contributed to strong economic development. By contrast, the monetary policy of the seventies favored the short-term temporal targets and was largely unable to cope with destabilizing situations affecting the Italian economy, sometimes worsening the situation and being the cause of destabilization. In addition, the monetary policy of the 1970s was, together with other factors, responsible for a marked inflationary process that was not seen since the world war and strong depreciation of the lira. While in the postwar period the main objective was price stability, In the 1970s the main objective of the fiscal policies became the employment support. This was the main motive for moving from a long-term strategy to a short one. The 1950s and 1960s were marked by high real growth and low inflation. The average real growth was 5.6%, and average inflation was 3.6%. Industrial growth, construction, investment rates and exports increased at rates ranging from 9% to 11% each year. These results were not fortuitous, both monetary and fiscal policies played a key role. Again, the monetary base shifted to 1969, and then resumed in the 1970s.

About the 1950-69 period, the average Italian inflation, though higher than that of the United States, Canada and Germany, was still lower than that of the United Kingdom, France and Japan. The same was for nominal interest rates (with the exception of France). With regard to real growth, Italy had the highest average rates only after in Japan and Germany. Contributing to real growth, in particular the positive change in the balance of payments, were also a series of acts aimed at commercial liberalization in Italy. On 15 July 1950, 39% of the imports of finished products were liberalized. On 20 September, free import rates rose to 66% for finished products, 82% for commodities, and 73% for foodstuffs. Commercial liberalization, among other things, not only forced domestic companies to become even more competitive, but also provided them with great opportunities in international markets. Italy could therefore rely on a non-indifferent amount of foreign currency, which gave it a good degree of monetary autonomy compared to external events.

This aspect was of fundamental importance for the continued pursuit of Italian monetary policy, for example in 1955-57, when Suez's political crisis, together with a high international crisis, caused inflationary and disproportionate tensions in the balance of payments. Monetary restrictions from various countries were implemented on this occasion, while Italy maintained the steady creation of liquidity. Even when production fluctuations occurred in 1958, foreign countries carried out very expansive monetary policies, while Italy reduced the official discount rate by half a point. To conclude, during the 1950s, Italy never resorted to open market operations, and modified only once the official discount rate and the mandatory reserve ratio. The balance of payments remained positive both in the 1950s and in the 1960s.

In 1961, however, the Bank of Italy began to stimulate the creation of a monetary base by depositing currencies at lending institutions. Moreover, in January 1962, in spite of the expansive phase of the economy, where prices and wages increased rapidly, and the balance of payments was approaching to take on a negative value, there was no immediate monetary tightening; in fact, the coefficient of compulsory reserve went from 25% to 22.5%. This maneuver increased the value of the monetary base by about 200 billion Liras. In addition, other expansive monetary policies were implemented in 1963, such as the reimbursement of up to 200 billion good maturities and the authorization of banks to replace long-term securities with cash and ordinary treasury bills required for issuance of circular checks. This led to an increase in liquidity of 100 billion Liras. As a result of expansive monetary policies and an overheating period, the external balance of the balance of payments in 1963 was now high (-1251 million dollars). In addition, the growth in domestic demand and inventory accumulation led to price destabilization and an increase in inflation. This also happed because in 1963 there was a first phase of wage claims. Despite the above situation, no monetary policy was used to block these trends. The mandatory reserve and the official discount rate were left unchanged, the lira was not devalued and the capital movements did not intervene. Only the net foreign credit position of the banks was reduced. Since all the banks were not creditors, this maneuver was a sterilization of the reserves. The consequence was therefore a reduction in the monetary base of about 400 billion lire. The foreign debt of banks went "from $ 1200 million in August 1963 to 634 at the end of 1964.

Although it happened late, the restrictive monetary policy was eventually implemented. The consequences was a slowdown in the annual rate of change in retail prices from 7.8% in 1963 to 5.8% in 1964. In 1964, the balance of payments returned to a better situation (from -1.25 in 1963 to +0.77 billion dollars in 1964). However, in 1965, the authorities began to implement an expanding monetary policy. By contrast, a policy of interest rate stabilization was announced in 1966. The goal of stabilization was to support the investments, pushing traders to accept lower returns in exchange for less volatility, hence facing a lower risk. The target stabilization rate was 6.5%. For the first time 6.5% was also the equilibrium rate, but in 1967 the rise in foreign exchange rates provoked a capital growth. The escape was so huge that despite the balance of current matches being positive, the balance of payments went from +324 to -1391 million dollars. To stop this trend and avoid losing an additional amount of international reserves, the authorities forced banks to reset foreign exposures and raise the unpaid interest rate swaps. So, in 1969, both short-term and long-term rates began to rise, and the official discount rate was changed from 3.5% to 4%.

This restrictive monetary policy had the merit of shifting the balance of payments in a single year from -1391 to +356 million dollars. All these virtuous and prudent policies, combined with a stable and credible monetary system like the Bretton Woods one, which among other things had the merit of increasing international trade between states, made the 1950-1969 a very florid period for the Italian economy, and as far as growth is concerned, it was certainly the best since the world war. Despite these remarkable advances, however, there were wage claims among the events that marked the end of the sixties. In this period (1970 to be precise), the new Workers' Statute was approved. With this new system, the social guarantees of citizens and workers were improved. Pensions were increased, maternity and unemployment protection was implemented, and finally the National Health Service was created. All these increases in public spending were not countered by adequate tax policies, such as an increase in taxation. Indeed, from 1970 to 1972, the monetary base made up of money to buy government debt securities (the Monetary Fund Treasury component) represented 9.3% of the annual growth of the currency. This figure is very important since in the previous twenty years it has never gone above 4%. Another reason of concern was that wage increases did not balance labor productivity proportionally, negatively affecting short-term and long-term supply.

4.1 The birth of the EMS

At the end of the seventies there was the will to make Europe an area characterized by strong monetary stability. Only a few years earlier, there had been the dissolution of the Bretton Woods agreements and it was therefore abandoned the fixed exchange rate regime. In addition, in 1973, there was the first oil shock that had sparked the rise in unemployment and inflation. It was therefore considered appropriate to return to a partial exchange rate stability. The solution that was implemented was the creation of the European Monetary System (EMS) in 1979. The rule on which EMS was based was that the various countries in the system should have prevented a currency fluctuation above + 2.25% / -2.25%. The only exception was made for the Italian lira, to which, up to 1989, a 6% / -6% variation was left. The EMS was therefore an attempt to bring in a similar system to Bretton Woods, but with a less binding freedom with respect to foreign exchange fluctuations. EMS, with the aim of stabilizing the currencies of the European area, was therefore one of the first steps towards the Euro project. One of the most important consequences of the creation of EMS was that the member countries and international organizations had to try to coordinate exchange rate policies in first person with the third countries.

4.2 How the EMS affected the Balance of Payments

When the lira entered EMS in 1979, the lira was one of the weakest coins in the system.

In order to respect the set exchange parity, a monetary policy needed to be fully in line with the external one. Indeed, an autonomous monetary policy would undermine a system of fixed exchange rates. Italy in the years of EMS chose an intermediate route. The effects of this choice can be found in the depreciation of the lira in the early years of the system.

In general, in the period between 1979 and 1991, various trends concerning Italy could be highlighted. First of all, average annual growth was 1.9%, while long-term growth was 2.74%. With regard to inflation, the average in the EMS period was 10.4%, the long-term rate of 4.4%. In 1981, there was the divorce between the Bank of Italy and the Treasury Department with the aim of making the Central Bank more independent and reducing the Treasury component of the monetary base with the ultimate goal of reducing inflation. However, the breakthrough was not immediate, since the contribution of the Treasury component to monetary growth was 197% in 1985, though to fall to 34% in the next five years. However, divorce was not a lasting and stable policy since in 1991 the Treasury component contributed 92% to the growth of the currency, and in 1992 even 291%. In the period 1981-83 income grew by only 0.6% per annum. Since 1984, however, the recovery started, the growth rate was 3%, which was always half that observed during the economic miracle, but better than that of previous years.

4.3 Italy from 1992 up to the entrance in the Eurozone

The years fro 1993 to 1998 were years of change for Italian fiscal and monetary policy. In fact, both the Government and the Bank of Italy pledged together to achieve the goals set out in the Maastricht Treaty to join the Euro, namely the convergence criteria relating in particular to the public deficit, public debt and the inflation rate. From the point of view of monetary policy, it was proposed by the Bank of Italy to implement the inflation targeting strategy. Inflation targeting is a monetary system in which the final target is expressed in terms of inflation rate, and all other objectives, such as income growth and employment, are subordinated to price stability. In addition, the central bank implementing this strategy is totally independent, but also responsible if the target is not pursued. The purpose of the Bank of Italy, by implementing such a strategy and by implementing a series of expeditious maneuvers, was to zero the inflation differential with other European countries. Given the above mentioned tax policies, there were also great improvements in public finances. Public spending in this period fell by five percentage points of GDP relative to EMS. In addition to the outflows, there was also an increase in tax revenues, plus 3.5% over the years of EMS. The end result was that the public deficit fell by 10%. These surprising results were not casual, as previously mentioned, the Bank of Italy committed itself to never achieving inflation targets, which is demonstrated by the fact that in the period 1993-1998 the rate of money creation declined 9%. Contributing to a marked decline in monetary terms was also an increase in the rate of circulation of currency, mainly due to the advent of new technologies. To conclude the comparison with the EMS years, it is worth adding that there was a fall in nominal interest rates, but an increase in real interest rates. Then the devaluation of the lira against the dollar was more pronounced than in the 1970s, which contributed to increase net exports and creating surpluses in the balance of payments. Given all these good and proactive results for entry into the single currency, it has to be said that real growth in the 1990s declined compared to the years of EMS.

To pursue the goal of entering the euro, restrictive fiscal and monetary policies were adopted in Italy. Although the objective was partially pursued and Italy was nevertheless judged eligible for entry into the Euro, government choices cost much to the country both in terms of GDP and employment. In addition, privatizations carried out in 1992 to raise funds were not as effective as they were thought to be. State funds were able to re-invigorate in the short term, but they gave up on long-term profits over time, while it was true that corporate profits increased under private management, but it is equally true that tariffs on major services which offered privatized companies such as highways, energy, water and bank fees, did so, bringing disadvantages to citizens.

4.4 The consequences of the entrance in the Eurozone for the Italian balance of payments

On January 1, 2002, the euro began to circulate. In Italy, the euro replaced the lira, and precisely one euro was 1936.27 liras worth. The years following the entry into the Euro followed the previous example of the nineties. Inflation was very low given the Maastricht criteria and the Stability and Growth Pact, and obviously the cancellation of the Treasury component of the monetary base. Real growth also stood on the same, very low levels as in previous years. There was a slight recovery in 2006, when growth was 1.9%, but all the possibilities for a strong recovery were cut off by the advent of the financial crisis of 2008.

In 2008, the one that was defined as the biggest economic and financial crisis since the 1929s broke out. The crisis did not directly hit Italy directly, as the exposure of national intermediaries to so-called toxic securities was not large compared to other much more active countries in this field. Italy was, however, hit indirectly, since the countries most affected by the crisis were very important outlets for Italian exports. So after the crisis hit the real economy of these states, imports of Italian products declined sharply, dropping net exports and consequently GDP, which declined in 2008 by 0.9% and in 2009 by 5, 2%. In this way there was a decrease in income also in Italy. In 2010, when the crisis seemed to end, there was a 1.5% increase in GDP, but it was only an illusion, as Italy was actually struggling to regain market share lost shortly before. Moreover, Italy began to pay for the consequences of its high public debt, as interventions were needed to rescue financial institutions in crisis. The Italian state therefore began to have trouble obtaining funds on capital markets and the interest rate on government bonds increased further. The more the spread grew, the more the Italian state lost credibility to international operators and less confidence they had in the Italian state and in its ability to repay the debts. In June 2011, the Italian situation broke out, parallel to that of Greece, Portugal and Spain, and the difference between Italian and German bonds stood at 500 points. Following these events, rating agencies rushed to downgrade Italian public debt. Such high interest rates were one of the causes that influenced the Italian real economy as well. Indeed, since the holdings of many Italian banks were the main holdings, when the yields rose so much, the value of these assets decreased equally rapidly, diminishing in turn the value of the assets of the banks. Given the precarious situation in the banking sector, these intermediaries were no longer able to lend at low rates, so there was a credit crunch, which made families and companies unable to access the credit. Hence, the decline in investment and the failure of many companies, especially medium-small ones, which until a few years earlier constituted the hard core of Italian industry. The Italian financial market situation began to improve only in 2012 when Prime Minister Mario Monti implemented a series of very unpopular measures to settle public accounts. The second reason was that the European Central Bank, led by Mario Draghi, started at the end of 2011 a long-term refinancing operation plan that ended only in early 2012. Through this funding the ECB provided liquidity to the Eurosystem's banks for an amount of one trillion Euros. The interest rate applied was also facilitated, in fact it was set at 1%. Despite the increased confidence in the markets, the restrictive policies of Prime Monti caused, among other things, a negative growth rate in 2012. In fact, real GDP declined by 2.4%. Since 2012, however, the Italian situation is improving both in terms of the real economy and confidence in the financial markets. The latter increased further only a few months ago thanks to quantitative easing, announced by the ECB in January 2015 and started in March of the same year to bring the inflation rate back to 2% after the risk of deflation.

5. The Current Exchange Rate System In Italy

5.1 Why choosing a flexible regime

Choosing to leave the exchange rate to float freely helps maintain the monetary policy control. Doing so, in front of a negative exogenous shock the policymaker can expand the money supply and diminish the interest rate, stimulating the economy and causing a depreciation of the exchange rate that makes exports more competitive and improving the commercial balance. The monetary autonomy can anyway represent a risk for the economies that not always have the necessary capability and credibility to follow economic anti-cyclical and not inflationary policies. Another advantage of the flexible arrangements than those fixed, is to be subject to attacks that can induce speculative currency crises.

5.2 Why choosing a fixed regime

A fixed exchange rate is a protection against adverse effects of the switches in the exchange rate. It also helps to facilitate the control of inflation but this advantage is valid as long as the country demonstrates the ability to maintain the fixed exchange rate. Moreover it facilitates the return of inflation to normal levels after inflationary crisis. A fixed rate can lower inflation by inducing greater policy discipline. It represents a highly visible commitment that raises the political cost of loose monetary and fiscal policies. Lowering inflation through a fixed exchange rate would carry a cost in terms of higher unemployment and lower output, owing to the restrictive policies followed in order to maintain that rate. The use of the exchange rate as a nominal anchor can discipline private agents too by changing their expectations, lowering the cost of attaining a low-inflation equilibrium. In addition, pegging the exchange rate can also lower inflation by producing a "confidence effect," for example a greater willingness to hold domestic currency rather than goods or foreign currencies, thus diminishing the inflationary effects of a given monetary expansion.

Under floating rates, expansionary macroeconomic policies can produce sudden and unwanted movements in exchange rates that represent an immediate and observable signal of fiscal indiscipline and can, in turn, impart discipline, whereas under fixed rates reserve changes usually can be concealed.

5.3 Current exchange rate

Italy is part of the Economic and Monetary Union using the Euro a single currency, inside the EMU the used exchange rate is the fixed one. At the moment the Italian currency exchange rate is approximately about €1 = $1.18 AUD. The flexible foreign exchange reference rates of the Euro are based on the procedure established by the European System of Central Banks. They are based on a daily concertation procedure between the leading central banks, which takes place at 14:15 (CET). The published exchange rates, which are the average of the sale and purchase rates, reflect the market conditions prevailing at the time of the concertation.

Historically, the Euro - Dollar Exchange Rate reached an all time high of 1.87 in July of 1973 and a record low of 0.70 in February of 1985.

The Euro Dollar relationship always showed severe oscillations. Reasons to explain this can be the external current account imbalances. Europe maintains its balanced current account whereas in the the U.S.A. this imbalance is enormous and this current account situation explains an important part of the volatility in the exchange rate.

The second cause for the volatilities of the exchange rate is the differential in the interest rate. When rates are higher in the U.S.A. than they are in Europe, Europeans bought dollars and thus benefit from interest rates higher there than in Italy.

From the beginning of the 2008 crisis, exchange rate rises and falls very quickly in the following years until the European Central Bank sets interest rates to zero, finally bringing down the exchange rate. Despite all this, the exchange rate remains stronger than the dollar, which makes Italy less competitive but also gives it a greater purchasing power.

The euro anyways is still in a favourable position. Indeed, the volatilities in our exchange rate against the dollar are small, dilated over time, predictable and perfectly explainable from the point of view of orthodox economic theory.

The debate on the pros and cons of the euro is based on the fact that on the one hand euro can be the only anchor that prevents peripheral countries from drifting into default, on the other hand it was pointed as the triggering cause of de- industrialisation and unemployment.

6. Conclusions

Looking at the history of monetary systems in Italy, it was noted that the economic situation and the responses of Italy, from a monetary and fiscal point of view, were much more virtuous when the external conditions to be respected were stricter.

In the 1950s and 1960s, this was possible thanks to a long-term government policy, which was primarily aimed at price stability. The change in the monetary base then shrunk and the public deficit was contained. Only in 1963, accompanied by the first waves of wage claims, and in 1967, accompanied by the rise in interest rates and the escaping of capital, there was an increase in the inflation rate and a significant deficit in the balance of payments. Economic growth was also significant, largely thanks to the help of Americans through the Marshall Plan, but also thanks to the commercial opening-up of a series of acts in the early 1950s, which led to increased foreign trade and exports.

In the 1970s and 1980s, after the end of Bretton Woods and the launch of the European Monetary System, characterized by a broader oscillation band for the Italian lira of 6%, also complicated exogenous factors such as wage claims and oil shocks, Italy failed to obtain the results in terms of debt, inflation and growth as the Bretton Woods system was in place and was unable to protect itself from speculative attacks that ended up with EMS. The most difficult problem to face during this period was the significant increase in the government deficit and debt as well as the monetization of the latter, which contributed to a marked increase in the monetary base through the Treasury component. The main reasons for the deficit, in addition to the shocks, were mainly political, such as the advent of the regions in 1972, which was a factor in increasing public spending as well as the growth of monetary stocks deriving from the monetization of debt. The latter, and therefore the monetary base stock, declined, though at times, only in 1981 after the divorce between the Bank of Italy and the Treasury. In the 1970s and 1980s, economic growth was much lower than that recorded in the years of Bretton Woods and even lower than that of the long-term. In spite of the low growth, Italy still managed to become the fifth industrial power in the world, given the further opening up of the country and the growth of small businesses, but also because other countries did not record good performance in this period, given the general repercussions of oil shocks.

This contained moderate growth in 1992 due to the currency crisis, seriously penalized Italy and increased the unemployment rate as well. In the same year, after the Treaty of Maastricht was signed, the Bank of Italy began adopting an inflation targeting strategy since 1993, which was mainly aimed at containment of inflation. The consequences were a sharp decline in monetary aggregates and therefore of inflation, despite the reduction of the mandatory reserve ratio to 2.5%, and a reduction in the public deficit to fall within Maastricht's parameters.

The joint efforts of central government and central government made Italy fit to enter the euro, despite the requirement of public debt being not satisfied. These restrictive policies, however, cost so much in terms of growth.

Regarding the entry into the Euro, in the light of the theory of optimal currency exchange rates, Europe could be considered an "ineffective currency area", as the divergences between states such as Germany and France, with others such as Greece and Portugal are too marked and the adjustment of foreign exchange to bring balance of balance payments was no longer possible with the introduction of a single currency. With regard to the sovereign debt crisis, one can not fail to recognize the considerable influence of finance on the policies of individual states, just as it did with Italy in 2011. The economic policies adopted in recent years have led to a further fall in the inflation rate, which ranged from 0%, far from the ECB's target, which is close to 2%.

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