

## International Movements of Bank Funds and Monetary Policy in Italy

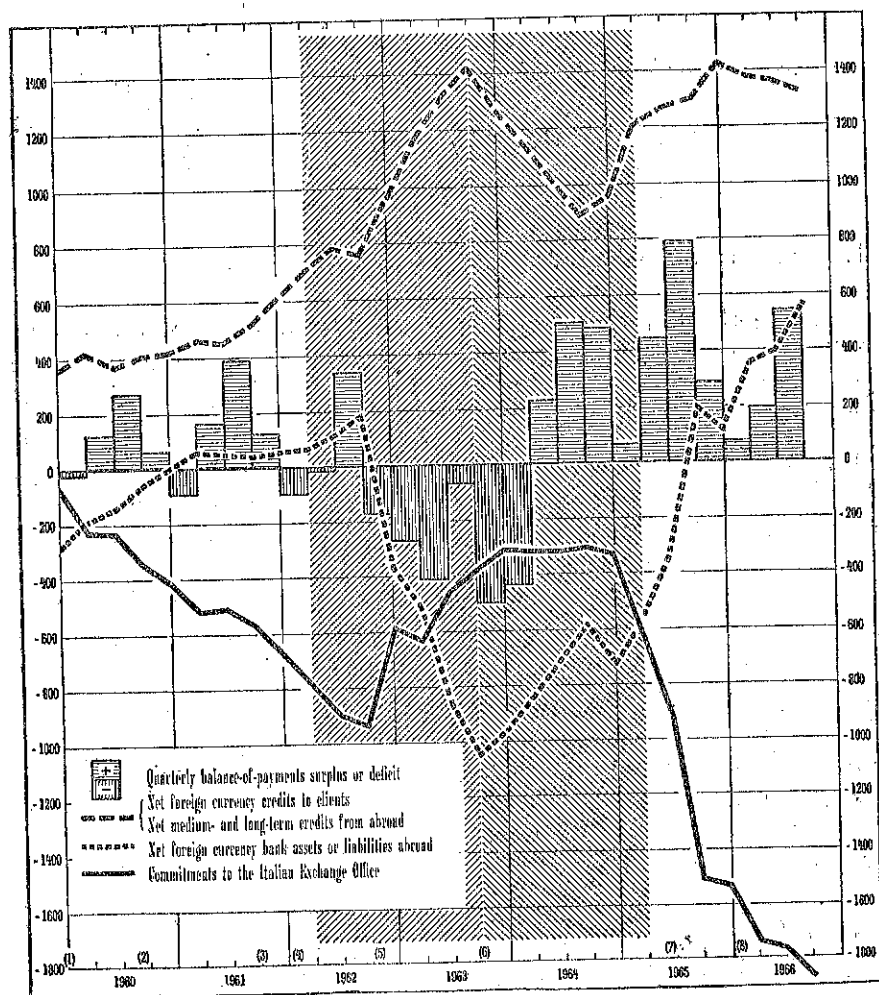
### 1. Sources of the banks' foreign currency supply

Since the lira was declared convertible in December 1958, the Italian monetary authorities have been making increasing use of changes in the Italian banks' foreign position as a policy instrument. This intervention technique was first applied, to a limited extent, in November 1955, when permission was given to the banks to acquire foreign exchange through lire swaps up to a predetermined ceiling, whereby they could cover forward liabilities in foreign exchange by forward lire assets. The acquisition of foreign currency in this way is still subject to the ceiling fixed for any disequilibrium of forward foreign exchange positions arising not only from the foregoing operations abroad but from those with residents as well. Initially, the ceiling was fixed at the equivalent of 37.5 million dollars; in November 1959 it was raised to 150 million dollars, and after several further increases it stood at 457 million dollars at the end of 1966.

Originally, the banks borrowed abroad for the twin purposes of getting additional liquidity for the requirements of the Italian market and enabling firms to obtain credit on more favourable terms, given that interest rates were lower on the international market than in Italy. But soon there was no longer any need to do so for reasons of domestic liquidity, and in the course of 1959 the existing differential in interest rates, too, diminished sharply.

In this new situation the monetary authorities felt it was time that Italian banks should finance their foreign currency credits to firms with the foreign exchange assets accumulated by the Italian Exchange Office. To this end, the banks were authorized to build up foreign currency holdings of their own by purchasing dollars from the Italian Exchange Office, either firm or with the right to sell back forward. In the first case, purchases and sales take place

FOREIGN EXCHANGE TRANSACTIONS BY ITALIAN BANKS  
AND THE BALANCE OF PAYMENTS (ON A PAYMENTS BASIS)  
(million dollars) CHART 1



- (1) November 1959: Banks are authorized to build up foreign currency holdings of their own.
- (2) August 1960: Banks are directed to liquidate their net foreign currency liabilities abroad.
- (3) Second half of 1961: The Italian Exchange Office deposits foreign currencies with the banks.
- (4) January 1962: The compulsory reserve ratio is lowered from 25 to 22.5 per cent.
- (5) October 1962: Banks are again authorized to maintain net foreign currency liabilities abroad.
- (6) September 1963: Banks are directed not to increase, and if possible to reduce, their net foreign indebtedness.
- (7) February 1965: The Italian Exchange Office discontinues foreign currency deposits with banks.
- (8) January 1966: The Italian Exchange Office limits its dollar sales with guaranteed repurchase rate to banks with net liabilities abroad. In the second half of the year these facilities are made available also to banks with net assets abroad, but subject to a premium of 2.5 per cent.

at the day's average official buying and selling rates, and in the second case the banks buy spot and sell forward at the same rate, with the option of renewal (generally at the end of the second month following the month of purchase). The overall ceiling, initially fixed at 150 million dollars, was subsequently gradually raised, and by December 1966 had reached a level of about 1,900 million dollars. In this way the banks were able to extend foreign exchange credits to Italian clients without incurring debts abroad, and could also use their foreign currency for deposits or short-term investment abroad.

Thanks to the facilities described above, Italian banks could acquire foreign exchange from both domestic and foreign sources, and lend it out both at home and abroad.

Side by side with their normal lire business, the banks thus developed a foreign exchange business, which helped to expand the volume of transactions settled in dollars and to supply funds to the international Euro-dollar market. The banks were quick to take advantage of the possibility of acquiring foreign currencies from the Exchange Office, with the result that, on the one hand, they incurred convertible currency commitments to the Exchange Office, mainly through swap operations, and, on the other, were able to dispense with foreign bank credits and also build up new assets abroad.

Between November 1959 and August 1960 the banks thus drew a net total of 262 million dollars from the Exchange Office, and at the same time improved their foreign position by an almost equal amount (Chart 1). Meanwhile, foreign currency credits to clients, which had been rising until the end of November 1959, remained virtually stationary. Two factors contributed to this: first of all, Euro-dollar rates were rising, and secondly the inter-bank agreement of September 1959 on minimum rates for foreign credits put a damper on the close competition of banks trying to acquire new clients through this channel.

## 2. Problems of domestic and international liquidity

Having thus allowed channels of communication to open up between the domestic and the foreign market, the central bank's general policy in controlling them was governed not only by domestic liquidity requirements, but also by the secondary purpose of helping to meet the international market's liquidity needs. A case

in point is the directive to the banks in August 1960, which enjoined them to liquidate their net foreign exchange indebtedness abroad by the end of the year (the time limit was subsequently extended by a month); when this measure was introduced, a balance-of-payments surplus was accumulating at an annual rate of about 500 million dollars and international liquidity was getting increasingly tight. In carrying out this directive, the banks chose not so much to reduce (to the extent of 32 million dollars) their liabilities abroad as to increase their assets (by 190 millions). One way in which the banks increased their foreign assets was to take advantage of the authorization given to them in September 1960 to finance short-term transactions for non-residents by discounting bills and documents.

### 3. Foreign currency deposits with the Italian Exchange Office

The Italian economy's growing liquidity gains through the balance of payments in 1961 were not sufficient to prevent the ratio of liquidity to deposits from declining sharply as a result of bank loans expanding by about 20 per cent and deposits by only 17 per cent. Lire/dollar swaps with the Italian Exchange Office therefore began to level out, while the banks' need for liquid lire assets became more acute. In face of this situation the monetary authorities in February 1961 permitted the banks to exclude forward operations from the calculation when making the required ascertainment of their foreign position balance, and this allowed them to draw on foreign exchange credits to finance domestic requirements, while always keeping below the ceiling fixed for this type of operation. However, the measure had little effect in practice, since lire had to be used to cover foreign exchange obtained abroad, so the authorities reinforced it by depositing some of the Italian Exchange Office's own dollars with the large banks that were suffering most from the liquidity shortage. These deposits bore interest at Bank rate, i.e. 3.5 per cent, and took two forms: either the Exchange Office deposited dollars outright with the banks, or else it closed a part of the swap operations outstanding with the banks, which meant repurchasing dollars previously sold against lire at a fixed rate, and simultaneously left the dollars in deposit with the banks.

This period was marked by the beginning of a phase of rapid expansion in production and growing intervention by the monetary

authorities. The great boom in industrial activity during the final months of 1961 was the culmination of an uninterrupted process of expansion that began at the end of 1958, and it brought our economy virtually up to the full-employment ceiling and to the limits of its productive capacity. Compared with the previous year, industrial investment was rising, at constant prices, at a rate of 19 per cent, and foreign demand was still so buoyant during the second half of 1961 that the overall balance-of-payments surplus went on expanding.

The year 1962 opened with a situation in which domestic demand was still growing and enormous investment programmes were in hand all through the economy — a legacy from a past of bright profit expectations. In January, the monetary authorities gave the economy a liquidity injection of something like 200 milliard lire by reducing the banks' compulsory reserve ratio from 25 to 22.5 per cent; at the same time, however, the foreign currency deposits with the banks, which had reached a peak of 302 million dollars in December 1961, were cut down to 118 millions. Deprived of these deposits, the banks began again to supply themselves with dollars through swaps under the spot-and-forward facilities.

In the course of the year far-reaching structural reforms were introduced, which led, among other things, to the nationalization of the electricity industry and the introduction of a withholding tax on equity dividends; at the same time, wages and salaries, in both the public administration and the private sector, entered a period of rapid rise.

### 4. Renewed bank borrowing abroad

A great many factors thus combined to create in Italy a situation in which all previous ratios between costs and benefits, between demand for consumer and for capital goods, between overall demand and supply, came to be radically altered — a situation, in short, which overturned the former pattern of production and disturbed the balance of payments.

Domestic liquidity increasingly went to swell demand for goods rather than their supply, and the interventions of the monetary authorities came to be governed more and more by the requirements of public administration, including those connected with electricity

nationalization, as well as by the finance needs of current investment programmes in both the public and the private sector.

Wages were rising faster than productivity, and prices, under pressure from foreign competition, failed to absorb the whole of the cost increases, so that companies saw their self-financing capacity shrink and had to rely more heavily on outside finance to complete the plant they had begun to build. The general shortfall in the expected flow of savings jeopardized even those investment projects which were nearly complete, and especially those large-scale and mostly public ones which were located in the Mezzogiorno and were intended to raise exports and reduce imports in the near future. There was a clear case for a differentiated policy mix combining restrictions on the capital market, with a view to discouraging new ventures, with plentiful credit, so as to enable production and current investment projects to go forward.

Bank liquidity continued to be boosted, especially by the reduction in the reserve ratio and by a widening of the disposable margin on open credit lines with the Bank of Italy; one of the most effective means was announced in October 1962, when the banks were again authorized to carry net foreign currency liabilities abroad. At once, the banks borrowed abroad more than enough to match the large deficits which were meanwhile accumulating in the balance of payments. Between November 1962 and August 1963 they took up foreign exchange credits abroad to an amount of 1,082 million dollars, and there was also a net increase of 136 million dollars in lire liabilities, while the overall balance-of-payments deficit was equivalent to 918 million dollars. A counterpart to these debts abroad was a further rise in foreign currency credits to domestic clients of 538 million dollars and a decline in dollar commitments to the Italian Exchange Office of 544 million dollars. In this latter case, the banks borrowed abroad because they needed to raise their liquid lire assets by cancelling a corresponding amount of dollar swaps.

Virtually all the funds which thus swelled the net foreign exchange liabilities of Italian banks came from the Euro-dollar market; as can be inferred from the quarterly statistics of the Italian Exchange Office, in September 1963 the Italian banks had a net debit position of 976 million dollars on the Euro-dollar market, compared with near-balance a year earlier.

### 5. Foreign bank credits and the adjustment process in the balance of payments

The Italian banks obtained the foregoing funds either through the intermediary of various European money markets, or directly in the form of deposits by non-residents. Without foreign bank credits, Italy could have run up such an overall deficit in her balance of payments only if the monetary authorities had replaced the corresponding liquidity losses through domestic liquidity creation, that is, if they had made inroads into official reserves. Ruling out this alternative, it must be conceded that foreign bank credits served to raise the growth rate of domestic demand and hence of imports. However, the use of foreign funds showed a tendency to widen more and more by a self-cumulative process, since it stimulated domestic demand and consequently pushed up the balance-of-payments deficit. It did nothing, in other words, to re-equilibrate the system. It was not until the final phase of this cycle, that is, after the middle of 1963, that demand for bank credit on foreign markets came up against a rise in borrowing costs which checked its further growth and, indeed, brought about its decline, in accordance, for that matter, with the directives that had in the meantime been issued by the monetary authorities.

The restrictive effect on domestic bank liquidity of the deficit phase of the Italian balance of payments (fourth quarter of 1962 to first quarter of 1964) was up to August 1963 more than offset by the increase in the Italian banks' indebtedness abroad; subsequently the situation changed drastically, since the repayments connected with the reduction of banking liabilities abroad came to be superimposed upon the external deficit.

Simultaneously with this development, from July 1963 onward the rate of expansion in bank credit at home began to slow down, following a deterioration in the economic situation, due to increases in the costs of labour and of outside finance for firms, which outpaced increases in productivity and prices. The banks themselves had to adopt a more cautious credit policy, in face of the monetary authorities' restrictions on liquidity creation, aimed at impeding a further rise of domestic prices and protecting the exchange rate of the lira.

The authorities did still create liquidity, but less of it reached the banks because of the large amount absorbed by the external

deficit. A more liberal policy would certainly have led to a growing gap between total demand and supply and the difference would have had to be met mainly by an increase in the external deficit; the ultimate consequence of such a process would have been the devaluation of the lira, and possibly more than once, because of the mechanism of the sliding cost-of-living bonus.

## 6. Curbing bank indebtedness abroad

The most far-reaching action which the monetary authorities took to contain inflationary pressure began in September 1963, when the banks were asked not to increase their net foreign indebtedness beyond its end-August level, and if possible to reduce it. This meant in effect freezing the Italian banks' sight assets abroad, in the amount of 573 million dollars; the result was that foreign currency credits at home had to be rationed and an additional strain was put on interest rates, which had already been rising on the European markets generally, not to speak of the extra rates charged at that time to Italian banks.

Stricter credit selectivity on the part of the banks, together with a rising tendency in domestic borrowing costs, led firms to raise more medium- and long-term funds abroad, while domestic bank credit declined as did, correspondingly, the banks' short-term foreign indebtedness. Foreign medium- and long-term credits increased by 545 million dollars between October 1963 and September 1964, compared with 196 millions during the previous twelve months; they took the form of security issues abroad, direct loans to companies and loans to industrial credit institutes. By contrast, foreign currency credits from abroad to Italian banks contracted between October 1963 and September 1964 by 466 million dollars, compared with a rise of 1,231 millions during the previous twelve months.

Thus the overall reduction in foreign credits from the first to the second of these two twelve-month periods was very large indeed, and it worked in a rather selective manner, in so far as it did not affect government-controlled firms or companies under foreign control, or, finally, some of the largest private Italian concerns.

Another factor which contributed to a change in the domestic situation was fiscal policy, for in the meantime certain measures had been adopted which had a restrictive effect on demand and profit expectations. The contraction of bank credit and of the banks'

foreign indebtedness had an immediate effect on foreign exchange expenditure for imports, and especially for advance settlement of imports. In the customs statistics, on the other hand, the reduction did not show up until some time later, because goods already paid for in earlier months still kept arriving.

These fiscal and, even more so, monetary measures were intended to restore balance between demand and supply in real terms; inevitably, they held back an increase not only in demand, but also in supply in all cases where the mechanism of resource allocation had been distorted by the expectation of rising prices.

During the first half of 1964 the downward movement of imports gathered speed under the combined impact of progressively weakening domestic demand, the disappearance of speculation occasioned by doubts about the parity of the lira, and new import regulations which required imports of certain consumer durables to be settled within thirty days before or after arrival, instead of the 360 days either way which were allowed previously. The gradual reduction of the Italian banks' indebtedness abroad was made irreversible by a series of formal instructions to the banks in the course of 1964; in January, the banks were told that they were not to increase their net foreign liabilities beyond the end-November or end-December 1963 level, whichever was the lower, and in July there followed similar instructions, the two key dates in this case being 15 and 30 June 1964.

## 7. The spot and forward rate of the lira

A few words may usefully be said at this point about the spot and forward rate of the lira during the period of external deficit. At the beginning, the monthly average of spot quotations against the dollar remained almost stationary, as it had been during the preceding surplus period, around a level just above the intervention point of 620.50 lire. From the second quarter of 1963 onwards, the seasonally adjusted dollar rate gradually rose to the year's maximum of 622.48 in October, then fluctuated narrowly around that level late in 1963 and early in 1964, and eventually rose to parity (625) in March, after the conclusion of the Washington financial agreements.

Thus the lira was allowed to move at the very moment when these financial agreements restored confidence in the maintenance

of the currency's parity. In point of fact, speculative movements had to some extent compelled the monetary authorities not to allow much flexibility in the exchange rate, even within the lire parity range agreed with the International Monetary Fund, for it was feared that at this stage of extreme balance-of-payments difficulties any change might be interpreted as a sign of impending devaluation and thus might set off even more active speculation.

Forward dealings in lire generated very strong speculative pressures in October and November 1963 and again during the first two weeks of March 1964, when the three-month discount soared to 7.5 per cent, even though the authorities intervened to the extent of 255 million dollars in support of the currency.

Although the monetary and fiscal measures which Italy had introduced were beginning to bite, in so far as the increase in domestic demand and imports had been slowing down since the autumn of 1963, the view prevailed even at the highest international level that these measures were not sufficient to restore external equilibrium. There was a strong current of opinion at that time that in the long run the only solution was to devalue the lira. Instead of letting up, speculative attacks on the lira were gathering new vigour, so much so that they became an autonomous factor threatening to bring about the very event which they purported to discount.

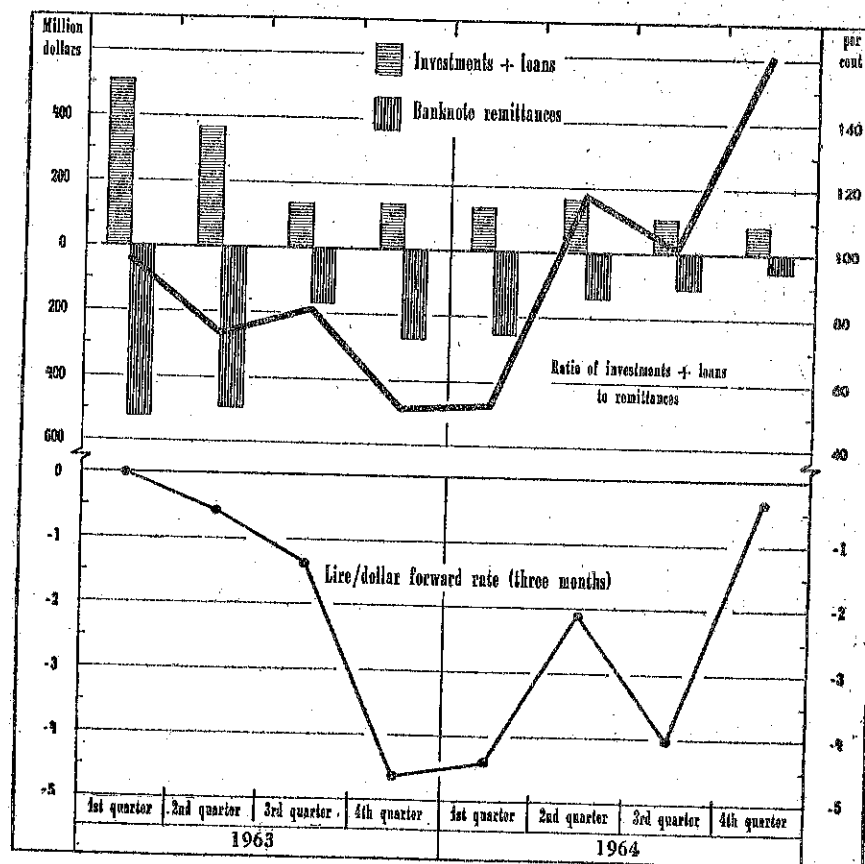
This is why the authorities thought it necessary to take steps in this specific sense and remove any doubts about the future of the lira by entering upon the Washington agreements with the United States Treasury, the Federal Reserve and a number of European central banks. It is common knowledge that the short-term facilities which thereby became available to us to defend the currency amounted to 533 million dollars, not to speak of an additional 450 million dollars in medium-term facilities from the Export-Import Bank and the Commodity Credit Corporation.

The pressures on the lira during the period when the balance of payments was in deficit were closely related with the outflow of capital through exports of Italian banknotes. Between October 1962 and March 1964 no less than 1,939 million dollar's worth of Italian banknotes was repatriated from abroad, in connection partly with fictitious capital transactions by which Italian residents invested in Italy under a foreign name, and partly with capital actually exported by residents. At an estimate, capital movements of this latter kind accounted for about 35 per cent of banknote remittances from

abroad. Given the speculative nature of these movements this percentage naturally did not remain constant over time; its fluctuations tended to display a positive correlation with the forward lire discount (Chart 2).

CAPITAL MOVEMENTS TO AND FROM SWITZERLAND  
AND THE LIRE/DOLLAR FORWARD RATE

CHART 2



## 8. The recent course of the Italian economy

Inflation generated by a rise of wages in excess of productivity and by the monetization of financial assets depressed investment and employment.

If economic growth, employment and wages are all to develop favourably, the prime objective must be to raise productivity; this

is the only thing of absolute value, in that it benefits employers and workers alike. It is true that monetary stability as such cannot safeguard growth and employment; but it is equally true that in an open economy growth and high employment are impossible without relative monetary stability. On past evidence it is perfectly possible to have at the same time strong growth, high employment and monetary stability, but only on condition that one fundamental requirement is fulfilled, and that requirement is a high increase in productivity.

The slow-down in the growth of real domestic demand, which appeared first and was most conspicuous in the capital goods sector and later spread also to consumer goods, did not make its full impact on real domestic supply, because foreign trade swiftly reversed course, which meant a growing expansion of exports and stationary imports.

In this cyclical setting, exports of goods and services expanded at an annual rate of 18 per cent between April and December 1964, and by 20 per cent in 1965; imports fell by 18 per cent in the first of these periods, and rose by 2 per cent in the second.

Since at the same time domestic demand for consumer and capital goods remained stationary, the additional real resources which the country produced at an annual rate of about 3 per cent went entirely to improving the balance of payments on goods and services account, where a deficit of 986 million dollars in 1963 gave way to a surplus of 308 million dollars in 1964 and 1,888 million dollars in 1965.

#### 9. Disappearance of the banks' foreign debts

In the banking system, this situation was reflected in deposits growing faster than credits, and both the banks' and the public's liquidity increased. In its turn, this higher liquidity pushed up the prices of fixed-interest securities (which had touched bottom around the middle of 1964) and so brought down yields, in spite of the large bond issues floated in the meantime. During the same period (April 1964 to December 1965), the banks used part of their excess liquidity to reduce their short-term indebtedness to the Bank of Italy and the Italian Exchange Office (by 460 milliard lire) and to lend abroad (770 milliard lire), especially on the Euro-dollar market where interest rates were rising after the United States introduced its well-

known restrictions on capital outflow. A contributory factor in the reduction of bank indebtedness was that, in February 1965, the Italian Exchange Office withdrew 86 milliard lire of its dollar deposits with Italian banks; these were replaced by lire/dollar swaps. Thus the international impact of Italy's current surplus was mitigated, so far as monetary movements were concerned, in so far as the banks reduced their net foreign indebtedness. For Italy herself, the effects of these operations were not completely symmetrical, since current assets in foreign currencies are counted as liquidities to the extent that they exceed the limit laid down by the monetary authorities.

#### 10. Latest developments in the Italian banks' foreign exchange position.

By all these operations during the phase of balance-of-payments surplus, the Italian banking system had virtually balanced its foreign exchange position vis-à-vis abroad by the end of 1965. There was no longer any need for the authorities to boost the outflow of bank assets to foreign markets through unconditional dollar sales with a guaranteed repurchase price. Since January 1966 the Italian Exchange Office has in fact been transacting such sales only with banks which still had net foreign liabilities, and on condition that the dollars so obtained be used to balance the foreign position. At the same time, the monetary authorities took steps to consolidate the banks' external equilibrium, and the latter are now no longer free to use their sight assets abroad unless these assets exceed liabilities.

With the balance of payments still comfortably in surplus throughout 1966 and rate levels remaining higher abroad than at home, the banks have been using their excess lire liquidities in lire/dollar swaps, even though a forward lire premium developed in the meantime; operations of this kind may not, of course, exceed the permissible limit fixed for them by the monetary authorities. Recently, the Exchange Office has again been selling dollars at a guaranteed rate, but is now charging a premium to banks with a balanced foreign position, which can thus go on acquiring dollars for credits to domestic clients. However, these latter were inclined in 1966 to prefer less costly lire credits, so that the total of outstanding foreign exchange credits to domestic clients fell slightly.

The trend of financings in foreign currency with respect to those in lire is linked not only with the trend of the relative rates but also with other factors, and above all (a) with the different incidence of the limits established by inter-bank agreements, less rigid and less extensive for financings in foreign currency, as in this case the agreements on the level of rates are drawn up only between the major banks; (b) with the different treatment as between lire and foreign currency deposits as regards the compulsory reserves, since the foreign currency deposits are excluded from the calculation.

By last October, the banks had built up net foreign exchange assets abroad in an amount of 580 million dollars, partly by market swaps and fixed-rate dollar swaps with the Italian Exchange Office, with or without payment of a premium, and partly by means of a reduction of foreign exchange credits at home.

Given the existing regulations, banks with net foreign exchange liabilities abroad which need currencies not to reduce these liabilities but to extend foreign exchange credits to domestic clients, now sometimes cover their requirements by buying foreign exchange against lire from banks with a net credit position abroad; this saves the premium to the Exchange Office. At the end of 1966 the banks' foreign exchange position abroad showed assets totalling 500 million dollars. Against this foreign exchange position was a lire liabilities position with a countervalue of 279 million dollars, consisting of balances of accounts opened in the names of non-residents for current transactions and capital movements, and including the lire/foreign exchange swaps mentioned above. The lire position is not calculated for the purpose of balancing the foreign accounts that the monetary authorities take into consideration.

## 11. Conclusions

The above account will have made it clear that the Italian monetary authorities have been using their powers to control the banks' foreign exchange borrowing and lending as a means to restrict or expand domestic liquidity.

Generally speaking, the flows of bank money to and from abroad have been so regulated by the central bank as to make the process of balance-of-payments adjustment more flexible, and hence to attenuate the effects of the liquidity gains and losses due to the

surpluses and deficits generated by autonomous operations with abroad. During the period from September 1963 to March 1964, however, when the authorities directed the banks to repay foreign credits at a time of balance-of-payments deficit, the effect was to speed up the process of adjustment, that is, to make it more rigid.

The Italian monetary authorities regulated the flows of liquidity between the domestic and foreign markets by granting or withdrawing from the banks the faculty of carrying net liabilities abroad. Allowing the banks to supplement their domestic resources by drawing on foreign credit made room for a credit expansion, just as if the central bank had increased its refinancing facilities to the banks or reduced the reserve requirements. Conversely, the contraction of foreign bank indebtedness in response to the monetary authorities' instructions had the same effect as a restriction of refinancing facilities or an increase in the reserve ratio. Operations on the international money market gave the banks alternative opportunities to place their resources in domestic or foreign assets without creating any problems of specific liquidity reserves, given that lire could be converted into dollars at a fixed rate, and *vice versa*, up to the amount of the outstanding operations in dollars, through the Italian Exchange Office. Thus sight deposits in foreign exchange became tantamount to lire reserves to the extent that the deposits exceeded the limits set by the Italian monetary authorities for net liabilities abroad; similarly, any unutilized margins of Exchange Office facilities could in effect be treated as disposable foreign exchange reserves.

Italian experience has once again provided confirmation that when bank credits are used without appropriate measures designed to re-establish basic equilibrium in the balance of payments, they may give rise to speculative capital movements which tend to aggravate the situation.

Either way, whether capital movements are due to interest differentials or to speculative motives, they restrict the monetary authorities' freedom of action to adjust the balance of payments in their own chosen time and manner, and on the basis of given levels of domestic demand and supply. However, the monetary authorities can exercise an indirect influence on capital movements through interventions in the forward exchange market, that is, through operations which modify or remove the forward premium or discount against the spot rate and thus alter the interest rate differential as between domestic and foreign markets. A pertinent example from



Italy is the swap operations by which the Exchange Office sells the banks dollars against lire, and guarantees to repurchase them at the same rate; in this case, there is no exchange risk and hence no need for forward cover, so that funds tend to move and liquidity to vary solely in response to interest rate differentials.

Furthermore, it must be remembered that it is in effect the U.S. Federal Reserve which assumes, and for substantial sums, the exchange risk for forward lire under the Exchange Office's fixed-rate swaps. In these circumstances, the whole set of operations which have been described here has done much to expand the size of the Euro-dollar market and hence to strengthen the position of the dollar as a currency of settlement for international financial operations. In the last analysis, the volume of Euro-dollar operations is a measure of the banks' additions to international liquidity, which help to expand intermediation between the United States savers' demand for long- and medium-term financial assets and the world's other, especially European, savers' demand for short-term financial assets. As with the exchange of goods and services, so does the exchange of these financial assets contribute to the optimal development in world production, by stimulating investment more particularly in those countries which display the strongest preference for holding savings in liquid form.

However, interventions on the forward exchange market may not be suitable or adequate to create the conditions in which a country's balance of payments can be adjusted without detriment to domestic employment and at the same time to the interests of other countries. It follows that we may not *a priori* rule out other schemes which involve direct controls of short-term capital movements. Italy's policy in this respect has been for the monetary authorities never to relinquish control of short-term capital movements; even when, in November 1959, the banks were authorized to build up their own holdings of foreign currencies, and when, in October 1962, they were freed from the prohibition to maintain a net foreign exchange debit balance abroad, all that happened was that the authorities gave the banks more freedom in the interests of domestic liquidity requirements, in accordance with directives laid down by the authorities themselves.

At the same time, the use of this liquidity control instrument has made it easier to pursue other, collateral objectives, including in particular those aimed at solving problems of financing international

trade and at curbing cyclical fluctuations in domestic interest rates, by encouraging in turn an inflow or an outflow of bank credits, due account being taken of the long-term relationships between interest rates at home and abroad.

Italian monetary policy made an effective impact on the course of the economic cycle, especially during the upswing, but it could not, of course, control the cycle by itself. In an open economy the objectives of full employment and balance-of-payments equilibrium can be made compatible with one another only through an effective incomes policy — assuming that such a thing is possible — and an efficient financial policy. The central bank collaborates in the full achievement of the two objectives indicated so long as the exchange parity of the currency is not jeopardized, so long, that is, as there is no question of transgressing the limits of the institutional purposes specifically given by government into the keeping of the central bank.

Rome

FRANCESCO MASERA