

The Control of Liquidity in Italy

I. Premise

In spite of the criticisms that have been levelled against the Radcliffe Report from various sides and on various grounds, one great merit it possesses must be recognized: it has thrown into relief the importance which must be attributed to the "control of liquidity", a factor that has come to the forefront, primarily in connection with the anticyclical policy, which is based on the regulation of the global demand for goods and services.

That control does not, indeed, imply substantial innovations in the conduct of monetary policy, so far generally understood as "control of money", or to be more precise, as control of its supply (1). Money, in fact, still continues to be, as we shall see, the main component of the supply of liquidity. More than anything else, therefore, the control of liquidity implies the extension of the control of money, understood as a means of payment, so as to take into account also quasi-money, understood as an asset capable of being rapidly changed into money without appreciable loss.

This extension is no novelty. It has almost invariably been taken into account in formulating the quantitative theory and the equation of exchange. Likewise in the conduct of monetary policy,

(1) According to the Radcliffe Report, the innovation would be substantial since "it is the liquidity of the economy rather than the 'supply of money' that the authorities should seek to affect by their use of monetary measures" (p. 4, para. 10). As R. Roosa emphasizes (in the October 1959 issue of *Lloyds Bank Review*) it would be more appropriate to say "the authorities should *not only* control the supply of money *but also* seek more broadly to affect the liquidity of the economy" (p. 3).

explicit reference has been widely made by the central banks not only to the trend of credit money in its typical forms of bank-notes and demand deposits, but also to the trend of the other engagements of the banking system (as, for example, in the case of Italy the "free and tied savings deposits") which are included precisely among the quasi-money. The novelty consists rather in the sharp emphasis given to such an extension, with greater awareness of its implications. It consists primarily in the inclusion among the liquid resources not only of the credits towards the Central Bank and the banking system but also of short term credits towards the State (such, in the case of Italy, as the ordinary Treasury bills). In this way, therefore, the State Treasury steps right on to the monetary policy stage as creator of liquidity and takes its place alongside the Central Bank and the banking system in the creation of liquid resources.

II. The liquidity of the banking system and the liquidity of the public

1. Let us now look a little more closely at what is meant by liquidity, or more exactly, by the "supply" (or gross availability) of liquid resources.

In this connection, economic theory tells us that liquid resources do not represent a category on their own of particular assets that can be clearly differentiated from other assets. We have rather a vast range of more or less liquid assets or "resources" that sometimes differ only very slightly one from another as concerns the "degree of liquidity" attributable to each of them, that is, we may repeat, as concerns their suitability to be rapidly changed into other assets such as money. It can therefore be understood why there is no complete uniformity among the various countries as to how liquid resources are to be identified. The points we shall develop regarding Italy do not therefore always correspond to the usages current in other countries.

2. In every country, nonetheless, a clear distinction is made between the supply of liquid resources at the disposal of the banking system and the supply of liquid resources at the disposal of the

"private sector" (2), or, put more briefly, between the liquidity of the banking system and the liquidity of the public. A distinction is also made, as regards both the banking system and the public, between "primary" liquidities and "secondary" liquidities.

In the case of Italy, from what can be inferred from the data published in the annual Reports of the Bank of Italy, the liquidity of the banking system is formed by the following assets or "reserves",

LIQUIDITY RESERVES OF THE BANKING SYSTEM

	In milliards of lire		In percentage of the total	
	31.12.1957	31.12.1958	31.12.1957	31.12.1958
Cash	97.8	104.8	2.7	2.4
Deposits at the Bank of Italy	48.0	77.4	1.3	1.8
Unutilized balances on Bank of Italy overdrafts	187.0	238.0	5.2	5.4
Ordinary Treasury bills and deposits at the Treasury	48.7	379.7	1.3	8.6
<i>Total primary reserves</i>	<i>381.5</i>	<i>799.9</i>	<i>10.5</i>	<i>18.2</i>
Statutory reserves (securities and cash)	1,163.9	1,387.7	31.9	31.6
Other State securities or comparable investments	351.5	414.2	9.6	9.4
Commercial bills	1,747.7	1,794.1	48.0	40.8
<i>Total secondary reserves</i>	<i>3,263.1</i>	<i>3,596.0</i>	<i>89.5</i>	<i>81.8</i>
<i>Total reserves</i>	<i>3,644.6</i>	<i>4,395.9</i>	<i>100.0</i>	<i>100.0</i>
Percentage ratio of primary reserves to deposits	5.9	10.6		
Percentage ratio of total reserves to deposits	56.1	58.3		

The liquidity of the public, instead, still taking as a basis what can be inferred from the Reports of the Bank of Italy, is formed as follows:

(2) By the private sector is meant the whole of the economic system less the banking sector, and the foreign sector, thus including in it not only the consumers (or the "householders") but also the producers (or the "firms").

LIQUID HOLDINGS OF THE PUBLIC

	In milliards of lire		In percentage of the total	
	31.12.1957	31.12.1958	31.12.1957	31.12.1958
Bank-notes at the Bank of Italy (plus coins)	1,851	2,005	21.2	20.3
Deposits in current account at the banks (including savings banks)	3,158	3,500	36.1	35.5
Deposits in current account at the Post Offices	107	117	1.2	1.2
Other items	149	212	1.7	2.2
<i>Total primary liquidities</i>	<i>5,266</i>	<i>5,834</i>	<i>60.2</i>	<i>59.2</i>
Ordinary Treasury bills	178	132	2.0	1.4
Savings deposits at the banks	2,706	3,208	30.9	32.5
Savings deposits at the Post Offices	218	254	2.5	2.5
Other items	388	437	4.4	4.4
<i>Total secondary liquidities</i>	<i>3,490</i>	<i>4,031</i>	<i>39.8</i>	<i>40.8</i>
<i>Total liquidity</i>	<i>8,756</i>	<i>9,865</i>	<i>100.0</i>	<i>100.0</i>
Percentage ratio of primary liquidities to gross national income	34.3	
Percentage ratio of total liquidity to gross national income	57.2	

3. Although the liquidity reserves of the banking system and the liquid holdings of the public are expressed in different ways, they have many common features. In fact, the primary liquidities of the banking system are formed essentially of credits of the system itself towards the Bank of Italy (in "cash" and in "deposits", as well as in the "unutilized balances on Bank of Italy overdrafts") and of credits towards the Treasury (in "ordinary Treasury bills" and in "deposits"), quite apart from that sum which is tied for compulsory reserves (and which is therefore attributed to the secondary reserves). In the liquidity of the public, too, credits vis-à-vis the Bank of Italy are included (in the first line of the primary liquidities) and towards the Treasury (in the first line of the secondary liquidities) (3).

(3) In addition to the data given in the two preceding Tables, the Report of the Bank of Italy for 1958 makes clear (in Table 136) that of the liquid resources created during that year by the Bank of Italy and the Treasury, for a total sum of 924 milliard lire, 717 milliards

Nonetheless, an essential difference exists that must be strongly emphasized. While the primary reserves of the banking system are formed exclusively by short term indebtedness of the Bank of Italy and the Treasury, the liquid holdings of the public, in addition to including such debt (as well as the indebtedness of the post offices, which in effect goes back to the Treasury), are also, and primarily, formed by short term indebtedness of the banking system: by deposits at the banks in current accounts (as primary liquidities) and by savings deposits (as secondary liquidities). Thus, while the Bank of Italy and the Treasury create liquidity in relation to both the banking system and the public, the banking system, in its turn, also contributes to the creation of liquidity in relation to the public. The banks therefore find themselves in the peculiar position of being "seekers" of liquidity in relation to the Bank of Italy and the Treasury, and "creators" of liquidity in relation to the public.

4. It is this creation of liquidity by the banking system that has gradually taken a preeminent place in the modern credit economies, so much so that the witty remark of Fisher can be applied to it — "It is no longer the dog that wags its tail. The tail now wags the dog", in the sense that bank-notes are no longer the dominant factor compared with deposits (4).

If this prevalence of deposits over bank-notes is explained on the one hand by the growing preference shown by the public, in its role of creditor of the banking system, for keeping deposits instead of bank-notes, it must also be explained, on the other hand, by the well-known "multiplier" effects that the credit facilities by the banking institutions, especially in the form of advances to the private sector, has on the volume of deposits (5). This is because — as is well known — on a given surplus of liquid reserves (beyond the quota tied as statutory reserves) the banks are in a position to make credit concessions, and as a reflex, to create deposits, for a

went to the reserves of the banking system and 207 milliards to the liquid holdings of the public. One infers, too (from Table 135) that of the preceding total sum of 924 milliards, 529 milliards can be ascribed to the creation of liquidity by the Bank of Italy and 395 milliards to the creation of liquidity by the Treasury.

(4) IRVING FISHER, in *The Money Illusion* (New York, 1928, 4th printing 1930, p. 129), was referring, when he made the remark quoted above, to the ratios between gold and the whole of credit money (bank-notes and deposits).

(5) To the notion of "multiplier" effects the Bank of Italy makes explicit reference in its Report for the year 1958, on page 299, as well as on page 310.

multiple, more or less elastic, of the surplus in question. In other words, the acquisition by the banking system of a given amount of liquid resources created by the Bank of Italy and the Treasury does not express itself only in a creation of deposits for the same amount, as if it were a simple substitution of bank-notes or Treasury bills by deposits, a substitution that would not entail an increase of the total liquidities of the public. Such an acquisition ends, through the concessions of credit by the banking system, rather in a creation of deposits for an amount higher than that of the liquid resources acquired by the banking system. So the creation of the deposits ends by effectively creating a liquidity for the public as a whole, through the multiplier effects of the credit concessions of the banking system.

5. In addition to the typical advances, as credits *vis-à-vis* the private sector, the purchases of Treasury bills, as credits *vis-à-vis* the public sector, also act in the same way.

That these purchases can have an influence on the creation of bank deposits in the same way as the credit facilities to the private sector is seen when the purchases are made from the public, which is credited, in a deposit account, with the value of the bills by the purchasing bank. If, indeed, the purchases are made directly from the Treasury by means of payment at the Bank of Italy, the result is a diminution of the primary reserves of the banking system. But this diminution can occur also in the case of credits opened to the private sector if the borrowers end by drawing bank-notes. This form of withdrawal can occur, and normally does occur, not only at the moment when the credit is granted but also, and indeed more especially, during the normal course of the "cash" transactions between banks and public, during which the public, in its role, we repeat, of creditor of the banking system, makes a choice deliberately or not, between keeping deposits or keeping bank-notes. It can therefore be stated that both the advances to the private sector and the purchases of Treasury bills can result either in the creation of bank deposits or in a diminution of the liquid reserves of the banking system on the Central Bank, according to the preferences shown by the public in the above mentioned choice.

As a matter of fact the advances to the private sector offer to the public as a whole wider opportunities to hold deposits and constitute at the same time a more direct stimulus towards these holdings.

They therefore end by exercising a greater influence on the multiplier effects, which are thus far more evident when the credit facilities of the banking system takes place through advances to the private sector rather than by means of the purchase of Treasury bills. For this reason the multiplier effects become more outstanding in periods of expansion of economic activities, during which the banking system can more easily increase the volume of its advances, while at the same time the public, as a reflex of the increase of income, is in a position to give, as a depositor, larger credit to the banking system. Then it is that the function of the banking system as "creator" of liquidity in relation to the public, by means of the multiplier effects becomes more evident.

6. Such creation is the reason why the trend of liquidity of the banking system in general comes to be very different from and, indeed, opposed to the trend of the liquidity of the public.

The creation of liquidity in favour of the public, as a counterpart of the credits granted by the banking system, acts in such a way that in face of the increase in the liquid resources in the hand of the public, there is a diminution of the liquidity of the banking system. The diminution can appear in absolute figures, that is, in the volume of the primary reserves of the banking system, if and insofar as the public, in face of the increased volume of deposits, begins to withdraw bank-notes, without the Central Bank increasing the circulation in the meantime (6). But also when, as generally happens, the credit expansion by the banking system is accompanied by increases in the circulation by the Central Bank, the diminution can show itself, and mostly does so, in the ratio between the primary reserves and deposits. Then, in fact, the reduction of the ratio can take place even without a diminution of the volume of the reserves (as the numerator) because of the increase in the volume of deposits

(6) In connection with what was stated in the text (para. 4) no diminution of reserves in absolute figures happens — *ceteris paribus* — when it is a question of purchases of ordinary Treasury bills carried out directly from the Treasury. In this case the banking system substitutes liquid reserves at the Bank of Italy with liquid reserves at the Treasury. While therefore it could remain indifferent in respect of the creation of bank deposits in the hands of the public whether the credits of the banking system are made by means of advances to the private sector or through purchases of ordinary Treasury bills, the same cannot be said in respect of the liquidity position of the banking system, which becomes diminished in the first case but not in the second.

(as the denominator). And it is this ratio which is the "North star" to which the banks look in regulating the trend of their credit activity.

7. The confirmation of this opposite trend of the liquidity of the banking system in respect of the liquidity of the public is afforded by the analysis of the "liquidity of the market and of the credit system" from 1948 to 1958, presented by the Bank of Italy in its Report for the year 1958 (and particularly in Table 144 and in Figure 44). While the primary reserves of the banks in relation to deposits are shown to have passed, through continuous fluctuations, from 17.5% in June 1948 to 9% in June 1958, on the other hand the total liquid holdings of the public showed a continuous rise which emerges also in the ratio between these holdings and the gross national income, which passed during the same period from 33% to 56.2%.

It can be taken that this tendency will be confirmed also in the data for 1959 that are expected to be announced by the Bank of Italy in its imminent Report for that year. On the basis of the figures so far available it is to be presumed that the liquidity of the banking system is decreasing (7). Against this the liquidity of the public has continued to show a persistent rise which showed itself (up to June 1959) not only in the absolute figures but also in the percentage increases, which are seen to be somewhat above the increase in the national income (8).

(7) This assumption is based on, among other things, the reversal of the tendency discernible in the ratio between advances and deposits even from September 1959;

	Deposits (1)	Advances (2)	Ratio (3-2:1)
	(milliards of lire)	(milliards of lire)	(%)
December 1957	6,496.0	4,882.3	75.2
June 1958	6,793.2	4,834.8	71.2
December 1958	7,551.7	5,147.6	68.5
June 1959	8,074.9	5,205.8	64.5
September 1959	8,246.0	5,375.9	65.2
December 1959	8,821.6	5,915.0 (*)	67.0

(*) Provisional data.

(8) This is inferred from the following Table, which lacks, compared with the complete picture given in Table 139 of the above mentioned Report of the Bank of Italy, the following elements that cannot be inferred from the periodical publications: "deposits at the Bank of

8. It is thus confirmed that, in relation primarily to the multiplier effects of the credits granted by the banking system, the liquidity of the banking system itself and the liquidity of the public are, as far as their trend is concerned, not only quite different things but even things one set against the other. However, going back to what has already been outlined (para. 5), it is a fact that through the said multiplier effects, as, for that matter, also through the simple substitution of liquidity already created by the Bank of Italy and the Treasury, the liquid holdings of the public are now formed primarily, and with a growing prevalence, by deposits that are created in the banking system (9). It is therefore easy to understand how, while the anticyclical policy based on the regulation of global demand is directed to regulating the supply of liquidity in the public's hands, nonetheless the "control of liquidity" by the monetary authorities consists primarily in the regulation of the liquidity of the banking system through regulation of the primary reserves that the system has at its disposal. In this way the control of liquidity of the banking system does not constitute an end in itself and should, instead, be understood as a means of controlling the liquidity of the public.

Italy" (less the money orders and cheques incorporated in the first column), "post office current accounts (net of the internal accounts)", "ordinary Treasury bills of the public". And account has not been taken of other elements that are not easy to work in. In any case, the total of the items considered represented, for the years from 1956 to 1958, from 92% to 94% of the total of the complete picture presented in the Report of the Bank of Italy.

CHIEF ITEMS OF THE LIQUID HOLDINGS OF THE PUBLIC

	Notes, coins money orders and circular cheques	Bank deposits (*)	Post Office Deposits	Total	Variations in the 12 months	
					Absolute figures	%
	(milliards of lire)					
31-12-1956	2,065	5,272	189	7,516	—	—
30-6-1957	1,871	5,350	200	7,421	—	—
31-12-1957	2,157	5,815	217	8,189	673	8.9
30-6-1958	1,991	6,035	230	8,256	835	11.2
31-12-1958	2,328	6,689	254	9,271	1,082	13.2
30-6-1959	2,221	7,134	270	9,625	1,369	16.6

(*) excluding the savings deposits tied at the Savings Banks.

(9) Thus, while the Table inserted in para. 2 shows that in Italy the liquid holdings of the public increased in 1958 by 1,109 milliiards, the Bank of Italy and the Treasury are shown as having contributed to that amount (as is indicated in note para. 3) only 207 milliiards. The difference of 902 milliiards would therefore represent the liquidity created for the public by the banking system.

But in assuming as a deciding factor of the liquidity of the public the liquidity of the banking system, the monetary authorities shall not lose sight of the contrast that can occur in the trend of one or the other form of liquidity. This contrast must be kept in mind, especially in the expansionary phases of economic activity, during which — as was seen (para. 6) — the ratio of liquidity of the banking system tends to reduce itself on its own, as a result of the credit expansion, while the liquidity of the public can increase until the margins of liquidity set beforehand by the banks are exhausted. It is then especially that a decrease of the liquidity of the banking system can imply an increase and not a diminution of the liquidity of the public so that one could be led to making erroneous forecasts by assuming that the trend of liquidity of the banking system is an "indicator" of the trend of the liquidity of the public.

III. The instruments of control

1. From what has now been said, the liquidity of the public — which has major economic significance as far as concerns the regulation of the global demand and therefore the anticyclical policy — must be controlled primarily through the liquidity of the banking system. This essentially means to regulate the creation of liquidity by the Bank of Italy and the Treasury, that is, to regulate the short term indebtedness of the Bank of Italy and the Treasury, which is directly reflected not only on the banking system but also on the public. Thus the instruments that serve, indirectly, to control the liquidity of the public, through the banking system, serve to control also directly the liquidity of the public.

This being established, we shall see (from para. 2 to para. 5) how the Bank of Italy can regulate the trend of its own indebtedness, which is essentially short term, and (from para. 6 to para. 8) how the short term indebtedness of the Treasury can be regulated or, better, how it can be contained.

There will then remain to be considered what instruments can influence the creation of liquidity by the banking system, by checking, or if necessary stimulating, the multiplier effects inherent in the lending activity of the system itself.

2. As far as the Bank of Italy is concerned, it is easy to infer from the ample documentation offered by the annual Reports the elements that give rise to its indebtedness. It is a question, in sub-

stance, of three elements, which refer respectively to the credits towards the banks and the private sector (advances), towards the foreign sector (financing of the gold and foreign exchange managed by the Italian Foreign Exchange Office), and towards the public sector, that is, towards the Treasury (purchases of Treasury and other securities also "for account of the Treasury", advances and financing of the "wheat stockpile"). Here are the figures of the variations in each of these elements and for the whole of them, from one year to another in the ten years 1949 to 1958 according to the summary given in the Report for the year 1958.

VARIATIONS IN MILLIARDS OF LIRE

	Private sector	Foreign sector	Public sector	Total
31-12-1949	2	246	- 60	188
31-12-1950	43	7	90	143
31-12-1951	- 11	127	125	241
31-12-1952	24	- 96	304	232
31-12-1953	- 9	- 55	242	178
31-12-1954	- 10	8	216	214
31-12-1955	- 31	44	253	266
31-12-1956	46	68	141	255
31-12-1957	- 38	196	88	246
31-12-1958	- 64	583	- 42	477

And here are the same variations shown as percentages, which give a better idea of what has been the weight of the individual elements year by year.

VARIATIONS BY PERCENTAGES

	Private sector	Foreign sector	Public sector	Total
31-12-1949	1.1	130.8	- 31.9	100
31-12-1950	30.1	4.9	65.0	100
31-12-1951	- 4.5	52.7	51.8	100
31-12-1952	10.4	- 41.4	131.0	100
31-12-1953	- 5.1	- 30.9	135.9	100
31-12-1954	- 4.6	3.7	100.9	100
31-12-1955	- 11.6	16.5	95.1	100
31-12-1956	18.0	26.7	53.3	100
31-12-1957	- 15.4	79.7	35.7	100
31-12-1958	- 13.4	122.2	- 8.8	100

3. It is thus clear how unimportant the advances of the Bank of Italy to the private sector, formed chiefly of advances on securities granted to the banks, have generally been as far as the creation of liquidity is concerned. The majority of the banks, in fact, are reluctant to have recourse to the rediscounting of their portfolio, with the exception of the portfolio for the wheat stockpile, the financing of which, as was said, is part of the transactions on behalf of the Treasury.

It also emerges how the variations concerning the foreign sector end, in general, by being opposed to those concerning the Treasury. This emerged especially in the year 1958 during which the surplus of the balance of payments and correlative purchases of gold and foreign currency made by the Italian Foreign Exchange Office, with funds supplied by the Bank of Italy, were the "main-spring" of the liquidity, in that they were transformed into a growing creation of liquid resources, which flowed both to the banks and to the private sector (as was made clear in note, Section II, para. 3). It was just this that enabled the Treasury to meet its "total requirements" by turning more to the banks and to the private sector rather than to the Bank of Italy.

4. This being the position, the question arises first of all whether, as to the creation of liquidity, regarded in its total volume, the monetary authorities can exercise an influence on all three of the sectors now considered, through the classical instrument of variations in the Bank rate.

The reply can only be negative as regards the private sector, given also that the variations of the advances to the sector itself have an almost negligible weight on the total. And the reply can only be negative also as far as the Treasury is concerned, since the trend of its resort to the Bank of Italy is almost independent of the level of the Bank rate.

The variations of the Bank rate could, instead, affect the foreign sector by, for example, attracting through increases of the rate foreign bank resources which could increase the surplus of the balance of payments and hence the creation of liquidity by the Bank of Italy. To such an influence should be attributed a "perverse" character as far as the anticyclical policy is concerned, since the increases of the rate, instead of causing an attenuation of the cycle,

as is normally expected, would end instead by causing, sooner or later, a revival of the global demand for goods and services as a reflex to the increased liquidity. In Italy, anyhow, the effects of the flow of foreign banks' funds are largely neutralized as far as the creation of liquidity by the Bank of Italy is concerned. In fact, 50% of the foreign banks' funds, expressed in Italian lire, are compulsorily kept apart by the banks in special non-interest bearing accounts ("M accounts") at the Bank of Italy, while the funds in foreign currency are handled by the authorized banks on their own, without giving rise, as would happen if they were surrendered to the Italian Foreign Exchange Office, to the creation of liquidity by the Bank of Italy. The influence of the flow of foreign bank funds on the liquidity of the banking system and of the private sector can therefore be noticed only indirectly, making itself felt either through the credit balances of the authorized banks with their foreign correspondents or through the foreign exchange credits that the banks themselves grant to their customers, especially for the payment of imports.

5. The influence that can be attributed to the classical instrument of the Bank rate, as far as the creation of liquidity by the Bank of Italy is concerned, thus appears to be rather negligible. So it remains to be seen what other instruments the monetary authorities have at their disposal, still in regard to the short term indebtedness of the Bank of Italy.

Undoubtedly, as regards the private sector, the monetary authorities, as was pointed out by the Governor of the Bank of Italy during a lecture given in Zurich in 1956 (10), "can allow or refuse the commercial banks rediscounting facilities and advances on securities". And, as far as the foreign sector is concerned, they are empowered to "grant or refuse the commercial banks loans in foreign currencies through the Italian Foreign Exchange Office, which, in turn, is financed by the Central Bank", and they can also "request the banks to be more liberal, or more sparing, in their use of credit facilities granted to them by their foreign correspondents" (11).

(10) Reproduced in English in the January-June issue, 1956, of this *Review*.

(11) In this sense, the "sterilization" of the foreign resources in Italian lire through the "M accounts" already mentioned in this article also plays its part.

Here we certainly have instruments that can be efficient in times of normal liquidity developments. It remains however to evaluate what their power can be in periods of exceptional expansion of liquidity due to a conspicuous and persistent surplus in the balance of payments, such as occurred in the year 1958, during which the surplus of 850 million dollars caused the creation of monetary resources by the Bank of Italy for 583 milliard lire (12). In such periods of so marked an expansion of liquidity, the need is more strongly felt of integrating the aforesaid instruments of a prevalently monetary character. Then it is only natural to rely on the already mentioned contrast between the variations concerning the foreign sector and the variations concerning the Treasury; to reduce, that is, in periods of a balance of payments surplus the interventions of the Central Bank in financing the needs of the Treasury, or even (as happened in the years 1949 and 1958) to invert the sign (from plus to minus) of the transactions with the Treasury (as is seen from the preceding Tables). This means to work in such a way that, as far as possible, the requirements of the Treasury should not be met by new short term indebtedness towards the Bank of Italy or that even the pre-existent indebtedness should be reduced.

6. But the containment of liquidity that can be achieved through lower short term indebtedness of the Treasury with the Bank of Italy would be lessened if — as frequently happens — that lower indebtedness caused, or anyhow were accompanied by, a greater short term indebtedness of the Treasury towards the banking system or the public. It is not enough, that is, to consider separately, as we have deliberately done so far, the creation of liquidity by the Bank of Italy; it is necessary to consider also the creation of liquidity by the Treasury through its indebtedness outside the Bank of Italy.

This creation of liquidity by the Treasury can occur in place of the creation of liquidity by the Bank of Italy, since — as has already been mentioned (para. 3) — the Treasury's possibility of having greater recourse to the banks and to the private sector, through the issue of its own bills, enables less resort to be made to the Bank of

(12) During 1959 there was a surplus in the balance of payments of 764 million dollars (a figure which, moreover, does not include the credit in lire made in favour of the International Monetary Fund for a countervalue of 202,5 million dollars). The creation of new monetary resources in face of this surplus was in 1959 569 milliard lire.

Italy for the funds necessary to cover the government cash requirements. Moreover, it is not only the cover for these requirements that in Italy determines the volume of Treasury bills in circulation, seeing that their issue is always available to the banks and to the private sector, which can ask for them on their own initiative according to whether it suits them to hold Treasury bills compared with other liquid resources. In such a case the proceeds from the issue of the bills flow into the Treasury accounts with the Bank of Italy, reducing their total debit balance: the reduced creation of liquidity by the Bank of Italy is then offset by the increased creation of liquidity by the Treasury.

7. From this point of view to consider, in the light of monetary policy, the whole supply of liquid resources (as is the tendency today) and not only the supply of money leads one to attribute less importance to the substitution of Bank of Italy indebtedness by Treasury indebtedness, since with both types of indebtedness the liquidity of the banking system and the liquidity of the public always ends by varying in the same sense. In this way (according to the tendency mentioned) one comes to consider it proper to give greater emphasis to the action of the Treasury, as creator of liquidity through the management of its own debt.

This does not rule out, however, as far as the process of income formation and other aspects of the economic activity are concerned, the fact that whether liquidity is created by the Bank of Italy or by the Treasury may have a different significance. It is necessary, that is, always to consider on a different plane the supply of money in relation to the supply of quasi-money, or rather the availability of primary liquidities in relation to the availability of secondary liquidities. This is not particularly noticed in Italy by the banks since it is left to the judgment of each of them to meet the reserve requirements by means of "cash" or "government securities". But the difference is more or less noticed by the banks themselves as regards free reserves and it is in any case noticed by the private sector. And this is why the open market operations by which one substitutes money to quasi-money (or vice-versa), can still be included among the instruments that can be used for the control of liquidity. Even if by their use the total volume of liquid resources does not change, the composition of the whole of them changes: even without a change of "quantity" there is a change of "quality", which is

anything but insignificant as regards economic effects. The Italian monetary authorities therefore quite rightly end, in spite of any appearance to the contrary, by making use of such open market operations, even if by methods different from those adopted in other countries. Thus among other things the "operations in securities on behalf of the Treasury" — through which, at the judgment of the monetary authorities, a more or less conspicuous part of the "cash" deposited by the banks as statutory reserves is employed — can be regarded as open market operations (1).

8. Such operations naturally cannot play a great part in the control of liquidity, especially if it is a case of absorbing liquidity already in existence, since, *inter alia*, an adequate availability of securities, which cannot always be arranged beforehand, would be necessary for this purpose, as well as an appropriate flexibility in placing them on the monetary market and, eventually, also on the capital market.

The best method to adopt for the control of liquidity, the more so if it is a question of absorbing liquidity created as a result of persistent surpluses in the balance of payments, is always that of consolidation of Treasury indebtedness, which, so long as it is kept on a short term basis, constitutes a source of liquidity for both the banking system and the public. And this is the instrument which, for more than a decade, has been largely resorted to in Italy by the monetary authorities. The Governor of the Bank of Italy recalled this during the lecture already mentioned. "The use of the instruments which I have described", he said, "has been supplemented since 1950 by the issuing, in the early months of each year, of nine-year government bonds, the so-called 'Buoni del Tesoro Novennali'. These bonds, which are placed on the market by the credit institutions, serve to absorb the excess liquidity which usually appears in my country towards the end of the year". Using the same method an attempt has been made to absorb, in addition to the excess amounts of a seasonal character, the exceptional volume of super-abundant liquidity created in Italy, beginning in 1958, by means of

(1) Such operations have represented an anything but negligible quota of the Bank of Italy's credits towards the Treasury: on December 31, 1958 out of a total of 1,804 milliard lire (including the "wheat stockpile") 325 milliards represented such operations. Noteworthy are the variations that occur in this particular item: from a maximum of 355 milliards at the end of December 1955 the total dropped to 128 milliards at the end of December 1959.

the issue of the loan of 300 milliards of 7-year Treasury bonds in August 1959 and the loan of 250 milliards of 9-year Treasury bonds in February 1960 (14).

It is clear, however, that the absorption of liquidity through the funding of Treasury short term debts can be definitive only insofar as the "total requirements" of the Treasury are kept within limits such as to enable them to be met by medium or long term indebtedness, that is, by recourse to the capital market — instead of by continuous new issues of ordinary Treasury bills, such as to leave unchanged, or even to increase, the total amount of bills in the hands of the banking system and the public. But it cannot be ignored that such conditions rarely occur in periods of liquidity expansion, during which the ease of placing ordinary Treasury bills can lead to deficit spending on a liberal scale, even on productive investments, raising the Treasury's "total requirements" beyond what is effectively placed on the capital market (15). This does not necessarily mean that the Budget must be balanced at all costs, but that the deficit must decisively be reduced, especially in the periods of expansion, so as to leave Treasury policy more room in which to manoeuvre as regards also the control of liquidity. This control is now one of the responsibilities that the Treasury is called upon to face in the management of its debt, responsibilities that have gradually made themselves more felt in relation also to the new directions of monetary policy mentioned in the premise.

9. All things considered, therefore, there is no lack of instruments through which the monetary authorities can vary the short term indebtedness of the Bank of Italy and the Treasury, thus directly influencing as much the liquidity of the banking system as the liquidity of the public.

As was made clear at the beginning, what is of interest is to control the liquidity of the public. And from this point of view,

(14) This last loan largely served (for the sum of 116 milliards) for the renewal of an equal amount of 9-year bills which had matured and not for the absorption of "fresh money".

(15) In Italy, as a matter of fact, the issues of Treasury bonds of the duration mentioned above served to arrest and, indeed, to lower the circulation of ordinary Treasury bills. After the upswing from the beginning of 1950 (with 1,243 milliards) until March 1959 (with 1,759 milliards), the maximum of 1,792 milliards was reached in July 1959, but since then there has been a decline in Treasury bills even though only slow, and the year 1959 closed with a figure of 1,770 milliards.

it is not a matter of indifference how the liquidities created by the Bank of Italy and the Treasury are divided between the banking system and the public. We know, in fact, that the resources that flow to the banking system give rise, on the part of the banking system itself, to a further creation of liquidity in the public's hands, leading to the "multiplier" effects that were dealt with at length (Section II, para. 4). Multiplier effects do not occur, instead, in the case of the resources that flow directly to the public. In other words, the flow of liquid resources to the banking system widens the base which supports the lending activity of the banking system with their multiplier effects on the liquidity of the public. If, therefore, that base is controlled, this can serve to contain the multiplication of the liquidity. In this sense, too, the monetary authorities can exert an influence, especially in connection with the consolidation of Treasury debts: it is not without importance in this case whether the placing of consolidated debts ends in a reabsorption of the liquidity at the disposal of the banks rather than of the liquidity in the hands of the public.

10. The monetary authorities can endeavour not only to control the base of the multiplier effects but also to contain, so to say, the "height" of the effects in question. They can, that is, ensure that the banks do not extend their credit lines up to the potential limits arising from the total of the liquid resources at their disposal.

An allusion in this sense is found in the mentioned lecture by the Governor of the Bank of Italy, who emphasized that the Central Bank "can apply, with varying degrees of liberality, its powers to authorise the commercial banks to grant credits which exceed a certain percentage, fixed by law, of their share capital and reserves". But, naturally, the variations of the reserve requirements could be far more efficacious with regard to the "height" of the multiplier effect. In fact, an increase of their ratios, equally if the reserves are formed of cash or of securities, results in the blocking of a part of the liquid resources at the disposal of the banking system, and they take on the character of secondary reserves, as they cannot be assigned to the resources available for immediate use, which every bank watches carefully like the "North star" in regulating the trend of its credit policy. The same occurs, of course,

but in a reverse sense, when there is a diminution of the reserve ratios.

These variations represent the instrument which is used in several countries to control the creation of liquidity by the banking system. In Italy, however, no opportunity of adopting it has so far occurred. Moreover an increase of the reserve requirements in the phases of credit expansion (phases that are generally marked by a reduction of the liquidity ratio of the banking system in face of an increase in the liquidity of the public) can entail a rather drastic credit squeeze for the banks which have not formed beforehand, among the primary reserves, adequate margins of resources in cash or in securities (16). It can therefore be understood how the increases of the compulsory reserves by the countries which follow this method are aimed rather at containing the creation of new liquid resources than at reabsorbing the liquid resources already created by the banking system. It seems therefore, that not even this is the instrument on which it is possible fully to rely in the event of exceptional increases in the liquidity of the public, due to conspicuous and persistent surpluses in the balance of payments.

Conclusions

1. In face of the greater complexity that the "control of liquidity" shows in respect of the pure and simple "control of money" the monetary authorities now have at their disposal a vast range of instruments that can make their influence felt, with varying efficiency, on the different aspects of liquidity.

In a general sense, a detailed examination of such instruments indicates that it is easier to contain than to reabsorb the liquidity that is created by the balance of payments surplus, a liquidity which, through the Central Bank, ends by permeating the banking system, with repercussions on the liquidity of the public of a multiplier character, which can become ever more marked as the liquidity ends by reviving the cycle, triggering off a growing credit expansion. In these circumstances, while every excess of liquidity of the banking system can gradually be reduced, until it disappears altogether, even

(16) To avoid a similar squeeze the statutory reserves were introduced in Italy in 1947 for the banks and in 1958 for the savings banks, accompanied by appropriate precautions to prevent the multiplier effects from acting to contract the credits already granted.

without the intervention of the monetary authorities, on the other hand a persistent superabundance of liquidity of the public can develop. This superabundance must be considered taking into account the already mentioned ratio between total liquidity and the national income. In fact, just as from their own point of view the banks look primarily at the ratio between primary reserves and deposits, so from the national point of view it is necessary to look primarily at the ratio between total liquidity and the national income and not only at the absolute figures of the liquid resources.

2. The increase of the said ratio, even if conspicuous (as is to be presumed occurred in Italy during 1959), should however be compared with the general tendency, which was not confined to Italy alone, towards increased holdings of liquid resources by the public, as a reverse manifestation of a diminished velocity in the use of the liquid resources. Thus the increase in the ratio does not signify, in itself, that there is a superabundance of liquidity of the same order. One cannot rule out, however, that the revival of the cycle may increase this velocity seeing that, among other things, the entrepreneurs may be led to utilize the balances formed beforehand during the recession phase.

In such case, there may not be a greater demand for liquid resources to be held such as to absorb the superabundant liquidity and to contain its effects on the level, *inter alia*, of prices and wages. Then the risks always latent in the free market economies could become enhanced: the risk, that is, of stimulating inflationary tendencies as well as tendencies towards freezing assets of the banking system. In this case, naturally, the monetary authorities would not hesitate to employ, even drastically, the instruments at their disposal so as to prevent the above mentioned tendencies from prevailing, as the Governor of the Bank of Italy gave warning in the "Final Considerations" of his Report for the year 1958.

3. Again, the more recent developments of the situation in Italy in relation to the rate of income formation, allow it to be assumed that "the policy aiming at preserving for the market an ample volume of liquid funds... even though the maintenance of a high degree of liquidity was... not without certain dangers" has been "favourable for the promotion of a more active phase in the field of investment", seeing that "a high degree of liquidity" can

be "capable of furthering, through... the fall in the cost of money, new investments" (17).

In other words, the superabundant liquidity, taken in its nominal monetary expression, seems about to be reabsorbed "physiologically" by means of the expansion of the real income regarded in its tangible forms. It would be this expansion of real income that would reduce the ratio of the liquidity of the public if and to the extent that the increase of the real income (as the denominator) should succeed in surpassing the increase of liquidity (as the numerator).

This is not, in any case, the only way to a "physiological" absorption of liquidity. Alongside it there remains open the way of expansion abroad: the opportunity, that is, of allowing the flow abroad, even for the transfer of capital, of the exchange reserves that can be assumed to be in excess — due account being taken of the larger purchases which it may be necessary to make abroad to strengthen the Italian productive structure. This can not only respond to well-founded motives of international solidarity, but also can prevent the persistence of a superabundant liquidity, beyond internal needs, from triggering off speculative movements, especially in the financial markets. In this sense, those who enjoy theoretical schemes realise that, notwithstanding the wide diversity of forms, the classical precepts of the "control of money" are still substantially valid for the "control of liquidity". That is, still holds good what D. Hume wrote more than two centuries ago, when he emphasized that "the same causes which would correct... exorbitant inequalities... must for ever, in all neighbouring nations, preserve money nearly proportion'd to the art and industry of each nation" (18).

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(17) BANCA D'ITALIA, *Report* for the year 1958.

(18) In the essay "Of the Balance of Trade", p. 83 of the 1752 edition of the *Political Discourses*.