Monetary Developments in Italy from the War Economy to Limited Convertibility (1935-1958) (*)

A) From the building up of the war economy to the Armistice (September 1943)

1. It is now roughly a quarter of a century since banking activities and foreign exchange transactions in Italy were given a new institutional framework. In the case of banking this has remained almost intact down to the present day. In the case of foreign exchange transactions it represented the first move towards increasingly rigid controls, from which the wheel later circled back towards freedom.

The new banking arrangements adopted between 1931 and 1936 were aimed at meeting the liquidity crisis caused by the world deflation of 1929-1933, and at henceforth confining the lending activities of banks to short-term credits.

Exchange control was introduced in late 1934 to deal with the weak foreign payments position, caused by general conditions abroad, by adverse capital movements (such as the purchase by the issuers and by other Italian investors of Italian securities issued abroad in previous years), and by the expenditures on supplies imported in preparation for the attack on Ethiopia which followed in October 1935. It became one of the main tools in the mobilization of resources to which the Italian economy was subjected for a whole

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decade (October 1935 to April 1945) by virtue of almost continuous involvement in military activities of greater or lesser importance.

Along with the ruin wrought by war, this control apparatus was inherited by the first democratic Governments of Italy. A recognition of its main pieces is required in order to follow the course of monetary events and policies during and after the Second World War.

2. During the eight years between January 1935 and February 1943, financial policy bore the mark of one man, Count Thaon di Revel, who throughout this period held the office of Minister of Finance. His challenging task was to devise a policy of controlling the inflationary pressure generated by military adventures in a structurally weak economy, which had already been put to a severe test by the choice in 1927, and the maintenance from 1928 to 1936, of an overvalued parity rate (the lira being one of the gold block currencies). In conjunction with the world depression, overvaluation of the lira had made for a slowing down of capital replacements and of expansion in industry during the thirties.

The Minister moved a two-fronted attack on the inflationary pressure which was present right from the beginning of his term of office and gathered strength as time passed.

On the one hand, he strove to prevent the formation of excess demand, directly restricting income payments by restraining wage and price movements through the corporative system. Upon Italy's entry into the war (June 1940) such controls were superseded by a general freeze.

On the other hand, he sought to check the pressure of excess purchasing power against the available goods and services, valued at the prevailing price level, by a variety of measures. These included rationing, and attempts to curtail private investment and consumption expenditures (or the accumulation of inactive balances) by directing towards the Treasury — through taxation or forced investment in Government securities — the abnormal profits of companies, the capital gains realized on securities or real estate, and other funds available for investment.

In 1935 a special tax of 10% (later 20%) was imposed on the income from bearer securities; and when, in 1941, it was made compulsory to register shares in the name of the owner, the tax remained in effect for registered securities. The maximum permissible dividend was fixed in 1935 at 6%; and after a few years' experimentation with a progressive tax on dividends the rate allowed was raised in 1940 to 7%. At the same time a new tax was introduced which practically blocked transfers of reserves to capital account by subjecting them to a rate of taxation amounting to confiscation. Excess profits due to war conditions became liable in 1940 to progressive taxation at rates varying between 10 and 60%, while what was left had to be invested, starting in 1942, in Nine-Year 3% Treasury Bonds.

In October 1936, the lira was *realigned* with the dollar at the 1927 parity of 19 lire to the dollar, i.e. it was devalued by 41%. On that occasion, a loan was floated which owners of real estate were made to take up compulsorily. This group was further hit by an extraordinary tax designed to service the loan. Shortly afterwards (February 1937) the transfer to capital account and the distribution of revaluation profits due to the « alignment » of the lira were forbidden.

On the occasion of the devaluation, an extraordinary 10% levy on the capital of incorporated businesses was also decreed. The levy was later (November 1938) extended to unincorporated businesses at a rate of 7.5%. In 1939, finally, a general capital levy of 0.50% was imposed.

Capital gains on real estate transactions — with prewar values as a reference — were taxed away to the extent of 60% in 1940. One year later capital gains realized on security sales were made liable to a progressive tax which, in 1942, was converted into a proportional tax of 20%.

The turnover tax on securities was raised on two occasions in 1938 and 1941, and in the latter year it was supplemented by a surtax of 4% (5% from 1942) on the value of the transaction.

A governmental authorization was required for the incorporation of new companies and for the issue of new shares and debentures after 1935; and in 1942 an obligation to invest in Nine-Year 3% Treasury Bonds one fifth of the funds raised by new capital issues was imposed upon companies. At the same time the subscribers to new issues were required to invest in Treasury Bonds a sum equal to the purchase price of the securities bought.

3. The policy which the measures just mentioned were designed to implement was characterized as one of the "circular flow of

finance funds" (*circuito dei capitali*). Besides enabling the Government to mop up private purchasing power for its own financing, it also purported to boost the morale of the country, by distributing equitably the burden of the war costs (1). However, the Government was unable to observe anything like financial orthodoxy, i.e. to keep its commitments within the limits set by tax revenues and the proceeds of long-term borrowing from the private sector. Liquid balances also rose, and were eventually drawn into the income circulation (2).

The formation of the additional liquid balances was based on Government recourse to central bank credit on which were pyramided commercial bank investments in Government securities. To obtain access to the central bank, the Government used a backdoor rather than expose its policies in the open. The Government's creditors were permitted to discount credits due under supply contracts or annual grants with the Syndicate for Advances on Industrial Securities (*Consorzio sovvenzioni su valori industriali*), an agency closely connected with the central bank which in turn stood ready to rediscount the relevant paper.

4. As the war proceeded, the pattern of liquidity holdings gradually changed: there was a shift away from current accounts at the banks and from Treasury bills towards bank notes. While the trend was upward both for the currency circulation and for deposits, sudden conversions of deposits into notes took place in every crisis, i.e. in September 1938 (Munich), August-September 1939, June 1940, September 1942 (air attacks), September 1943. Though these movements were generally reversed when the crisis was over, the long-term rate of expansion was higher for currency than for deposits. Among the factors making for this change, were the displacement of persons, the general feeling of uncertainty, the development of black market activities, and the rise in the income of the farmers relative to that of other groups (3).

(1) P. Thaon di Revel, "La finanza di guerra", *Rivista di scienze economiche*, March 1942.

(2) Reference is here made to the model of money flows presented by F. W. Paish, "Open and Repressed Inflation", *The Economic Journal*, September 1953.

(3) About the impact of war scares and war loans on the development and the composition of the money supply, see V. Azzolini, "I riflessi della guerra sui fenomeni della moneta e del credito", *Rivista bancaria*, February 1943.

In order to mop up liquidity, the Government made every year one or two big issues of Nine-Year Treasury Bonds, through a banking syndicate headed by the Bank of Italy. The syndicate provided temporary credit facilities for the subscribers, by bank advances with the newly issued bonds as collateral security, as has continued to be the practice up to the present time. The degree of success of these operations in the war years may be measured by comparing the proceeds of each issue with the liquidity holdings outstanding at the time of the issue (Table 1).

Table 1

WAR-TIME ISSUES OF TREASURY BONDS

(*billions of lire*)

Date of issue	Liquidity holdings (1)				Amount placed	
	Currency	Current accounts	Treasury Notes (2)	Total	billion lire	% of total liquidity holdings
1940: February	30.3	25.7	10.4	66.4	10.3	15.5
1941: February	38.7	33.1	15.9	87.7	15.0	17.1
September	47.3	40.3	19.2	106.8	20.5	19.2
1942: April	61.3	47.2	24.4	132.9	24.4	18.4
September	69.5	49.8	25.0	144.3	17.8	12.3
1943: June	102.9	65.6	20.8	189.3	11.6	6.1

(1) At nearest recording date preceding issue.
(2) Mainly at and not above one year maturity. Holdings by banks are excluded.

Between February 1940 and September 1942, total liquid holdings increased from 66 to 144 billion lire, or by 68 billion, notwithstanding the draining away of 88 billion through the issue of Treasury Bonds. Since the highest ratios of the proceeds for the issues to the amount of liquid assets outstanding were attained in 1942, it would appear that the inflationary element in the pattern of war finance did not grow in importance during the first two years of the war. In fact, the figures in Table 2 show that, according to this measure, the inflationary element was even smaller than it had been immediately preceding the war. A somewhat different picture emerges from a division between classes of lenders rather than between debt instruments. This division is also shown in

Table 2. According to this second criterion, the deterioration appears to have started in 1942.

Under a regulation issued by the bank control authorities, in February 1943, the big banks were obliged to keep additional loans, other than those made for recognized war purposes, within one fourth of the increment in deposits.

TABLE 2

GOVERNMENT BORROWING BY TYPE OF DEBT AND CLASS OF LENDER

Years	Amount borrowed	of which floating debt	of which from the banking system (1)
	(billions of lire)	(in % of total borrowing)	
1938	11.2	60.3	29.9
1939	13.9	76.7	60.4
1940	37.4	59.3	46.9
1941	71.0	38.1	36.6
1942	98.0	37.3	47.0
1943	152.3	86.1	91.8
1944–1945	572.0	76.0	76.9

(1) Including Treasury currency.

5. Down to the autumn of 1942, the inflationary effect of war-finance showed up in the accumulation of liquidity holdings rather than in increased spending. Controls on the volume of consumption and investment expenditures were applied with a certain measure of success. The achievement of a rough balance between the supply of and the demand for resources for non-war purposes was facilitated by the fact that, notwithstanding the totalitarian political regime, an all-out national war effort was never made. Conversion to war production was less complete than it had been during the First World War. The sceptical attitude of civil servants, the business community and the public in general towards the aims of the regime contributed to this failure. As a result, production for civilian consumption did not suffer as much as might have been expected.

The pressure of the inflationary tide, from both the supply and the demand side, gradually increased as time passed, owing to the dislocation of the production and distribution processes and to the expansion in the volume of money. The breaches in the wall of controls grew wide in the autumn of 1942, when the fortunes of war turned decidedly against the Axis powers. This was the time of the first mass air attacks on Italian towns, attacks which brought home to the general public the realities of the situation and broke up the unity of the market by disrupting the transport system. The increase in prices, which by then were on the average roughly twice the pre-war level, was accelerated and black market transactions spread. A run for cash led to a shortage of notes which was overcome with some difficulty.

With the acceleration of price increases, and the distortion of income distribution away from its peace-time pattern, the technical and ethical foundations of Count di Revel's system were weakened. Reference to pre-war values became meaningless; and the confiscation of the spurious capital gains due to the general price rise appeared patently unjust, rather than conducive to an equitable distribution of the burden of war expenditures. But the transition from repressed to open inflation was only partial. The maintenance of certain effective controls (such as those applying to the basic crops, to public utilities and to rents), and the physical lack of spending opportunities, both for consumers and for business, meant that the excess liquidity of the "disequilibrium system" (4) was kept in existence until the end of the war. This is shown by the movement in the income velocity of money, and by that in the ratio of bank loans to deposits (Chart 1). In fact, the process of liquidity formation continued for almost a year after the liberation.

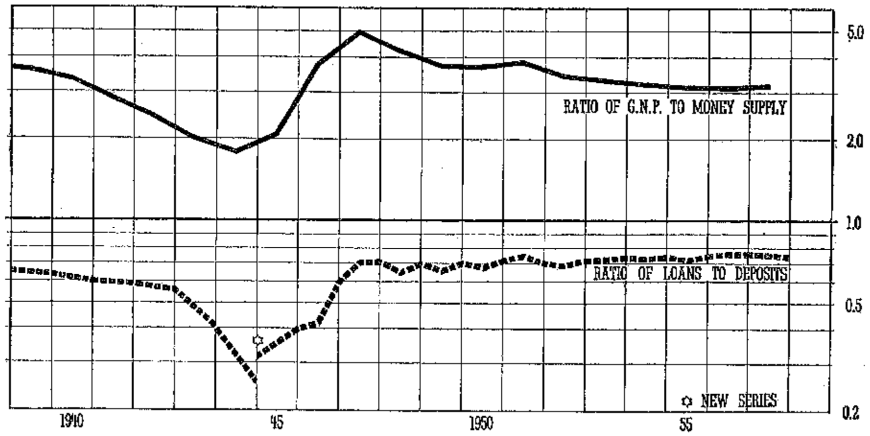
However, the shift to the holding of notes was accentuated in the last pre-Armistice year and during the occupation, so that Government finance had to rely more and more on the printing press. The poor yield of the June 1943 issue of Treasury Bonds was evidence of the change in atmosphere. The Allied landing in Sicily followed shortly afterwards on July 10.

At the time of the landing, controlled prices in Italy were between two and three times the pre-war levels. On the free

(4) J. K. GALBRAITH, "The Disequilibrium System", *American Economic Review*, June 1947; A. J. BROWN, *The Great Inflation, 1939-1951*, Oxford University Press, 1955.

markets and in clandestine and semi-clandestine transactions, prices had soared to levels that were — according to the records of the Chambers of Commerce which collect price statistics all over the

CHART 1 - INCOME VELOCITY OF MONEY AND RATIO OF BANK LOANS TO DEPOSITS, 1938 to 1958



country — from five to ten times the pre-war ones, the highest peaks being in the prices of foodstuffs, imported raw materials and manufactured products with a high import content.

B) **Military occupation** (September 1943 to April 1945)

6. The landing was followed, within two weeks, by the collapse of the Fascist regime. Negotiations for an Armistice were begun shortly afterwards by the new Government headed by Marshal Badoglio, and a ceasefire was agreed upon for September 8. The months that followed the Armistice were among the darkest in Italy's history. After two months of eclipse, Mussolini came back under German tutelage. An underground movement developed in the German occupied regions, and regular Italian forces fought on both sides. The Allies' progress up the peninsula, which had been rapid at first, was stalled by the obstinate German resistance at Cassino until May 1944. Rome was liberated at the beginning of June, but another eleven months were to elapse before the obstacle

of the fortified defense line in the Northern Appennines — the "Gothic line" — was overcome. The whole of the agriculturally rich and highly industrialized Po Valley thus remained under the control of the Germans until the eve of their final surrender.

Monetary developments during the twenty-one and a half months of actual warfare on Italian soil were marked by the adoption of purely inflationary methods of war finance (No. 7), while production slumped (No. 8), and by differences between the German-occupied and the liberated regions in the pace and nature of the inflationary process (No. 9).

7. In the German occupied regions, long-term borrowing had no part in the finances of the Fascist and German rulers. The Germans exacted from the Fascist Treasury a war contribution totalling 184 billion lire during the nineteen and a half months of their occupation. The Fascist authorities spent for their own purposes, during the same period, about 170 billion lire, of which some 50 billion were drawn from taxation.

The joint rate of spending of the two administrations having the right of coinage and taxation in the North thus appears to have been slightly below 20 billion lire per month. An idea of the relative magnitude of this figure may be obtained by comparing it with the rate of about 3 billion lire per month, for Italy as a whole, in the last peace-time fiscal year (July 1938 to June 1939). The income in real terms of the German controlled regions in 1944/1945 was probably about one third of Italy's income in 1938.

The 120 billion lire which the Fascist Treasury drew from the banking system came in part from the central bank, as direct advances, but mostly from the commercial banks, either directly or *via* the central bank. The commercial banks took over limited amounts of Treasury Notes, and placed deposits with the Treasury (a transaction implying the transfer to the Treasury's account at the Bank of Italy of deposits held by the commercial banks with the latter). Commercial bank deposits at two weeks' notice, bearing interest at 3 per cent, were also accepted by the Bank of Italy and largely invested in Treasury Notes. The flow of funds into these deposits was very large, both because the banks were reluctant to finance the moribund Fascist Government directly, by the purchase of securities, and because the uncertainty of the moment made it seem advisable to keep as liquid as possible.

Even granted that this return flow of funds from the commercial banks was based on the large-scale creation of central bank credit for account of the Treasury, its size indicates that the demand for credit on the part of the private sector was — owing to the falling level of activity and dwindling stocks — extremely low. The ratio of loans and advances to total commercial bank assets decreased continually between the armistice and the liberation. The assets structure of the main Milan banks at the time of the liberation (April 1945) was roughly as follows (figures are percentages of liabilities): cash 3, deposits with the central bank and the Treasury 66, Treasury Notes 7, other investments 7, loans 12, other items 5.

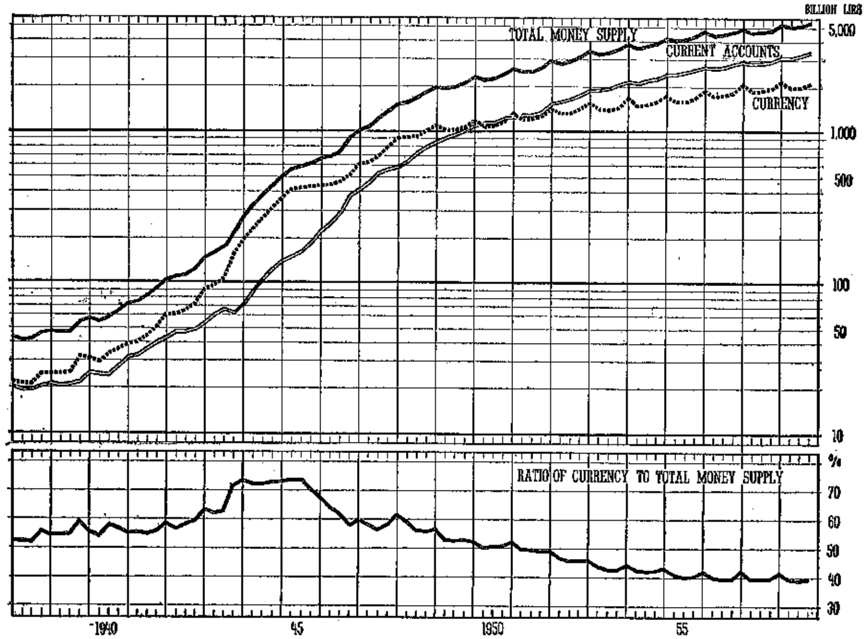
Much as this state of affairs relieved the strain on the printing presses, the quantity of notes drawn into active circulation or into hoards was still large; and toward the end of the occupation a shortage developed, possibly caused in part by go-slow policies. One result was that, at the moment of the German surrender, there stood on the books of the Bank of Italy an entry to the credit of the Germans of about 13 billion lire, representing balances not yet paid because of the lack of bank notes. The shortage of bank notes induced commercial banks to issue bearer cheques in fixed denominations. This " Ersatz " money disappeared after the liberation, but the problem of an adequate supply of bank notes was soon to re-emerge in connection with the plans for a currency purge.

The increase in the note issue, in the German occupied regions, between August 1943 and April 1945, reached 159 billion lire. It represented 65% of the total increase in the note issue (from 116 to 361 billion lire) for the country as a whole between these dates. The issue of allied military currency (amlire) accounted for most (32%) of the remaining 35%, while the residual 3% consisted of Bank of Italy notes issued in the liberated regions to meet the needs of the Government and of the economy. It is fair to add, however, that part of the notes issued by the Allies was used to provide assistance to Italian local authorities for civilian needs (5).

(5) For a detailed analysis, see the *Bank of Italy Report for 1945*, p. 67 ff.

It is worth noting that the Badoglio Government succeeded in covering its financial requirements without making much use of the printing press. This was due to the limited scope of its activities and to the success of a new instrument of short-term finance. The issue of the usual Treasury Notes maturing after one year was suspended for a time in the areas under Allied military rule. Neither

CHART 2 - THE MONEY SUPPLY AND ITS COMPOSITION, 1938 to 1958



such notes nor the Post Office Savings Certificates (also maturing after one year) were readily accepted by the investors under the conditions of great uncertainty then prevailing.

In the circumstances, it was decided that the Bank of Italy (which operates a branch in every province) should accept from the banks, in addition to the ordinary deposits at one and two weeks' notice, special time deposits at 3 and 4 months' notice, bearing interest at 4 and 4½ per cent respectively. Given the large issue of currency by the allied authorities, and the low demand for credit from the private sector, the volume of funds flowing into these

TABLE 3

MAIN ITEMS IN BANK OF ITALY POSITION (1)
(billions of lire)

	December 1938	August 1943	June 1945	September 1947	December 1957
FOREIGN ASSETS (2)	4.0	2.5	0.6	12.0	719.2
Transactions with the Government:					
Investment of banks' deposits (3)		8.0	68.0	65.0	345.0
Other investments and advances	10.6 (4)	115.7 (4)	470.1 (4)	616.0 (5)	1,138.5 (5)
Current account balance	*0.9*	3.7	*27.6*	17.3	169.7
NET LENDING TO THE GOVERNMENT	9.7	120.0	510.5	698.3	1,653.4
Transactions with banks:					
Discounts and advances	5.5	7.7	6.8	48.1 (6)	306.0 (6)
Statutory reserves	—	—	—	4.0	545.2
Other deposits	*0.5*	*12.8*	*120.1*	66.8	*71.0*
NET LENDING TO (OR BORROWING FROM) BANKS	5.0	*5.1*	*113.3*	*22.7*	*310.2*
NOTE ISSUE	19.0	115.6	370.5	667.7	1,913.7
OTHER ITEMS	0.3	1.8	27.3	19.9	148.7

(1) Figures in italics show Bank of Ialy liabilities.
(2) Bank of Italy holdings plus credit extended to the Exchange Office for the acquisition of gold and foreign exchange.
(3) Investments under this heading are regulated by special agreements between the Treasury and the Bank of Italy and related to the balances outstanding on time and statutory deposits of commercial and savings banks at the Bank of Italy; however, the amounts invested are generally lower than the amounts of such deposits.
(4) Including IRI funded debt and claims on *Consorzio sovvenzioni su valori industriali* arising from Government contracts.
(5) Including, in 1947, the whole amount of rediscounted wheat bills; for 1957, the part of such amount pertaining to previous crop years.
(6) See previous footnote.

accounts was very high. " Except for some purchases of Treasury notes and advances to the Consorzi agrari, the banks were chiefly engaged in the business of receiving deposits and passing the funds on to the Banca d'Italia " (6).

Intermediate-term borrowing by the Badoglio Government was resumed, on the eve of the liberation of the North, with the Soleri loan, which will be described later on.

For the country as a whole, the rate of increase in the note issue during the nineteen and a half months from the Armistice to the liberation was higher than it had been in the previous war years or than it was to be in the inflation of 1946/1947 (Chart 2). The role which commercial bank deposits with the Bank of Italy played, on both sides of the front line, in Government finance, is shown by the changes in the Bank's position from August 1943 to June 1945 (Table 3).

8. The purchasing power of the lira fell faster in those fateful months than at any other time in the twenty years under review. The impact of the rapidly expanding money supply was made stronger by the fall in production. In industry, the most serious difficulties came from the growing shortage of fuel and raw materials, for which the heavily industrialized North was largely dependent on imports from abroad (cotton, wool, woodpulp, rubber, copper) or from Southern Italy. In Mid-1944 the Gothic line had cut off from the North the three main mining districts (Tuscany, Sardinia and Sicily) normally supplying iron ore, pyrites, mercury, coal, lignite, zinc, lead and sulphur. At the end of 1944 already, pig iron production in the regions under German occupation had fallen to about one-fifth of the 1939 level, and steel production had dropped to one-third. The important rayon industry was largely inactive; and the output of textiles, chemicals, cement and building materials had been reduced to extremely low levels (7). Only the production of electricity, being mostly based in the North on the utilization of the water power resources of the Alps, could continue

(6) F. A. SOUTHARD, *The Finances of European Liberation*, p. 96 (The Carnegie Endowment for International Peace, 1946).

(7) COMMISSARIATO NAZIONALE DEI PREZZI, *Rassegna di congiuntura*, No. 1, January 1945.

at a steady level both before and after the liberation; neither the Allied air offensive nor the German retreat caused serious damage to the power stations.

The 1945 indices (8) of the volume of industrial production in the main sectors, for the whole of the country, were as follows (1938 = 100):

Mining	31
Metalworking	16
Iron and steel	18
Automobiles	20
Chemicals	11
Cement	11
Electricity	86
Textiles:	
Raw silk	29
Cotton spinning	8
Cotton weaving	12
Rayon	3

In agriculture production had dropped by 1944 to 76% of the 1938 level. The following year, 1945, was even less favourable, yielding only 55 to 60% of the 1938 crop. Among the chief factors responsible for such disappointing results, was the shortage of high-grade seeds, fertilizers and pesticides, all of which had been growing progressively scarcer since the start of the war. Unfavourable weather conditions compromised the situation still more; a long drought destroyed crops and pastures. Since direct consumption by agricultural producers did not appreciably contract, the fall of production to a little over half of normal meant a reduction of the volume of farm produce actually marketed to about one-third of normal (9).

(8) Computed by F. Coppola d'Anna, "Il reddito nazionale italiano nel 1945", *Congiuntura economica*, November 1946.

(9) A review of the situation is presented in P. Albertario, "Aspetti apparenti e reali dell'odierna situazione alimentare", *Socialismo*, January-February 1946.

The gross national product at 1938 prices is estimated to have fallen from 153 billion lire in 1938, and 129 in 1943, to 95 in 1944, and 77 in 1945 (10).

Of less immediate consequence was the plundering of resources by the invaders on both sides of the fighting line. This mostly took the form of deforestation in the South, and of the mass deportation of industrial workers, the dismantling of well-equipped factories, and the looting of gold (95 tons) and of art treasures in the North.

9. The inflation of the money supply was more disruptive in the small and primitive economy of the liberated South than in the more affluent and more highly organised economy of the regions under German occupation (11). The continuity of administration in the latter regions made it possible for the rationing and price control system to be effectively maintained over a wider range of goods and services up to the end of the war.

In the rump economy of Southern Italy, the control apparatus and its Fascist cadres were swept away in the transition to Allied military rule. With the rebirth of an independent trade union movement, the price-wage spiral soon came into play.

At the end of the war the average price level was still markedly lower North of the Gothic line than in the liberated areas. This

(10) Istituto Centrale di Statistica, *Annali di statistica*, series VIII, vol. 9.

F. Coppola d'Anna, *op. cit.*, arrived at the following estimates for the net product of economic activities, by sector, at 1938 prices (*in billions of lire*):

	1938	1945	1945 : 1938
Agriculture	43.1	25.7	.60
Manufacturing	40.0	10.0	.25
Trade	10.4	4.5	.43
Building	6.7	5.7	.85
Professions	18.2	13.5	.75
	118.4	59.4	.50

(11) "In Naples, no less than in Sicily, the impact of the Allied occupation was immediately and intensely inflationary, and the attempt to hold prices at the existing level broke down completely, not without a considerable diminution in the prestige of AMGOT, which found itself quite unable to enforce its regulations. With the official rate of exchange at 400 to the pound sterling and a military wage-rate often more than twice the existing rate for civil labour, the task was hopeless". (C. R. S. Harris, *Allied Military Administration of Italy 1943-1945*, Her Majesty's Stationery Office, London, 1957, p. 90).

fact suggested for a time to the Allied authorities the desirability of regulating commercial intercourse between the two parts of the country in order to avoid the spread of inflation from the South to the North. As had happened in other parts of the world (Australia, South America), two years of isolation had exhausted the agricultural South's supplies of manufactured products, including not only machine tools and spare parts, but also the most indispensable consumers' goods. The North, on the other hand, was running short of several foodstuffs produced by the Southern regions, such as olive oil, citrus fruits and salt. The powerful pressure that had thus developed in favour of prompt and total economic reunification led in fact to a quick resumption of trade in both directions; it took place both through the normal channels and through improvised middlemen that sprang up in great numbers in response to the emergency.

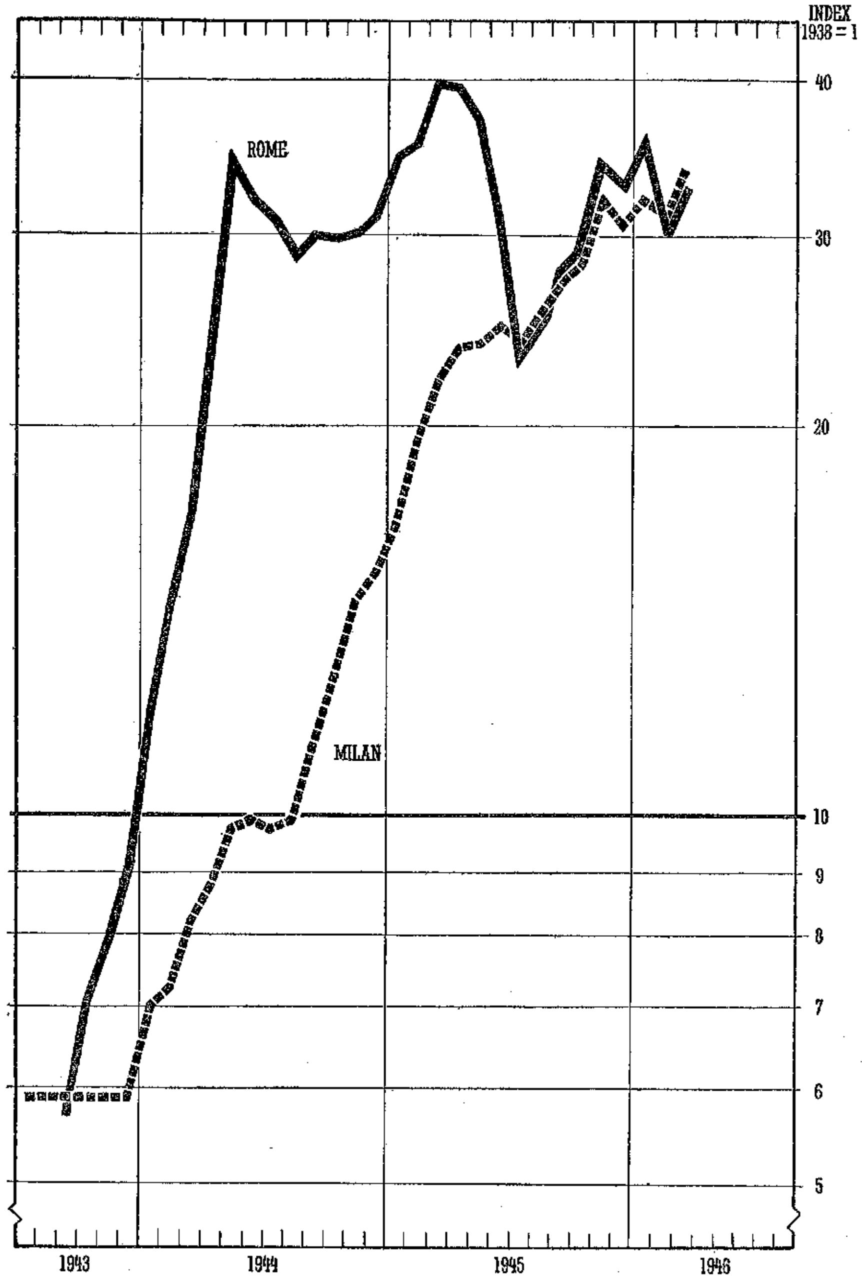
This resulted at first in a fall of the price level prevailing in the central and southern regions towards the price level in the Po Valley. The downward movement is apparent in Chart 3, depicting the course of food prices in the two largest Italian cities, Rome, south of the Gothic line, and Milan, north of it.

In the country as a whole, the upward movement was resumed in the second half of the year for food prices, owing to the bad crops. For other goods inflation marked time, and some prices even fell (No. 11).

Reflecting the uneven incidence of controls, together with differences in supply conditions and in income elasticities of demand, the bundle of price indices opened out like a fan while the war proceeded. In 1945, after the liberation of the entire country, the indices (on the base 1938 = 1) of a substantial group of prices (free market prices of foodstuffs and textiles) were in the neigbourhood of 40. At the same time there were nearly as many official prices for the agricultural products that had to be delivered to the administrative authorities for distribution, and public utility rates that had barely reached 10 or (as in the case of urban rents) had not changed at all since 1938.

The rise in wages was kept in check for almost three years under the June 1940 price- and wage-stop. Up to April 1943, the wage-stop was tempered only by increases in family allowances, by two bonuses disbursed in June 1941 (two and a half weeks' pay)

CHART 3 - COST OF LIVING (FOODSTUFFS), 1943 to 1946



and in November 1942 (one week's pay) and by certain payments in kind. When these additional items are taken into account, the increase in average hourly pay up to April 1943 works out at about one-third. Meals in factory canteens and the allocation of goods (outside the general rationing system) at reduced prices helped keep down the cost of living for employed workers. In April 1943, an extra allowance per *day* worked (*indennità di presenza*), equal to between one-third and one-fourth of the basic wage rate, was introduced.

As with prices, the advance in wages after the Allied landing proceeded faster South of the front line than North of it (Chart 6).

Since the relative weight of free prices was heavier in the South than in the North, wages in the South did not lag much behind free prices, while in the North they did not run very far ahead of controlled prices.

In December 1943, the military Government of the liberated areas decreed wage increases ranging from 10 to 70%. This first measure was followed by the introduction, starting in August 1944, of a "cost of living allowance". In February 1945, the latter was replaced by a "contingency allowance", a term designed to emphasize the provisional character of this solution to a problem that, with the restoration of stable economic conditions, would have to be dealt with by a revision of basic wage rates. Though the allowance differed as between male and female workers, it was otherwise uniform except for a supplement payable to the head of the household.

In the German occupied regions, the basic rates were increased by 30 per cent (15 per cent in the upper wage groups) in December 1943. A war allowance was added to the *indennità di presenza* in September 1944.

Even when account is taken of the importance for working class households of the foodstuffs obtainable at stable prices under the rationing system, it appears that by 1945 real wages in the German occupied regions had fallen to about one half their 1938 level, or roughly in line with the reduction in national income.

In nominal terms, the take home pay including all the "extraordinary" allowances of a skilled worker in Milan, at the beginning of 1945, was not more than 4 or 5 times that of 1938; for unskilled workers and women the ratio was 5 or 6 to one.

At the same time, in the regions under Allied control, wages had already reached a level 10 to 15 times that of prewar (12).

Both North and South of the front line, the war-time additions to the basic pay were uniform in amount for all workers or for broad groups defined by sex, age or number of dependents. This lack of diversification resulted in a marked levelling of the remuneration of the various wage and salary groups towards the subsistence standards of unskilled factory hands and of female workers.

C) **Early peace-time ebb and flow of inflation** (May 1945 to September 1947)

10. The open inflation already present in the South might have been expected to spread to Northern Italy with the liberation. The extreme liquidity of the banks at the time reflected a state of high liquidity for the private sector as a whole. The ratio of the monetary stock to the gross national product was 55 per cent in 1944 and 47 per cent in 1945, as against 28 per cent in 1938 (Table 4

TABLE 4

THE MONEY SUPPLY IN RELATION TO G N P

(billions of lire)

Years	Currency (1)	Current accounts (2)	Money Supply	G N P	Ratio of Money Supply to G N P
1938	22.1	20.1	42.2	152.8	*27.7*
1944	274.0	106.0	380.0	686.0	*55.4*
1945	419.0	168.0	587.0	1,254.0	*46.8*
1947	716.0	518.0	1,234.0	5,992.0	*20.6*
1957	1,897.0	2,911.0	4,808.0	14,805.0	*32.5*

(1) Including circular checks.
(2) These include business deposits (conti correnti di corrispondenza) and other check accounts (conti correnti ordinari).

(12) Wage trends are analyzed for the period 1945-1949, in *Rassegna di congiuntura, cit.* and in F. AMBROGI, "Le retribuzioni dei dipendenti dell'industria dal 1938 al 1949", *Rassegna di statistiche del lavoro*, May-June 1949.

and Chart 1). The private sector's net liquidity (calculated by deducting borrowing at the banks from holdings of cash and deposits) was also high, since the credit expansion had served almost entirely to meet the claims of the Treasury. In terms of sector analysis, a high net liquidity of business and persons was offset by the negative liquidity of the Treasury, the net liquidity of the country as a whole — after the looting of the Bank of Italy's gold — being practically nil. Inside the private sector, liquid balances were presumably very unevenly distributed. This condition reflected the distortion in the income pattern which had developed since 1938 as a result of the gradual concentration of civilian demand on prime necessities, and of the unequal effectiveness of price controls in various segments of the economy. Farmers and tradespeople fared better than other occupational groups and better than holders of money claims (13).

The income velocity of money (and hence the inflationary potential) at the time of liberation was affected by a number of unusual factors.

The fall in national income was accompanied by a more than proportional contraction of produce offered for sale, while production for own use was less affected. The need for cash in current market transactions was thus reduced more than in proportion to the fall in income. Moreover, the distortion in the pattern of wages and prices was such as to make for a higher average frequency of recurrent payments. The lessening of wage differentials caused the relative weight of weekly wage payments to factory workers to increase in comparison with that of monthly salary payments to office workers. The retention of the controls on rents and on public utility rates (electricity, telephone, gas) held in check a mass of payments which take place at relatively long intervals, ranging from one month to one year, and which entail the building up of substantial cash balances between successive disbursements. The lower incidence of direct taxes, payable every other month, also helped reduce the need for cash balances. The concentration of spending on foodstuffs largely eliminated the liquidity needs to finance the purchase of durable and semi-durable consumers' goods.

All the above factors made for an increased velocity of circulation; however, this tendency was to a certain extent offset by other factors operating in the opposite direction. The high prices of foodstuffs had meant gains for the farmers, who are as a class inclined to banknote hoarding, and were the more so inclined given the difficulty of finding on the market either capital goods or manufactured consumers' goods.

To sum up: the position was one in which the dilemma of open inflation or a monetary purge was not inescapable. It admitted of a third possibility — a policy of holding back so as to allow time for the increase in production, and the restoration of a normal price pattern, to equate liquidity needs with the existing money stock at the then ruling price level, except for two upward adjustments:

(a) an immediate one, directed towards bringing controlled prices in the North into line with the wage level already attained in the South (No. 19);

(b) a slow one, directed towards restoring a normal price pattern through gradual decontrol.

11. Actual developments up to the spring of 1946 were promising in this respect (Chart 4).

The prevailing attitude was one of confidence in the recovery of the purchasing power of the lira. The steep climb in prices of the preceding two years was mainly ascribed to war-time scarcities; and the liberation by America was expected to bring better times. While this attitude lasted, the public held back from spending, and the price level for the whole country remained roughly stable, while the regional spread contracted. On the side of business, the limitations on production imposed by the low supplies of fuel and raw

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(13) The main sufferers were of course middle class groups depending for their living on fixed incomes: depositors in savings accounts, holders of Government securities and of life insurance policies, pensioners, owners of rented urban and rural property. In contrast to the experience after the First World War, the reaction of this class to the loss of "unearned income" was to avail itself of such opportunities for work and gain as the country's economic expansion offered, rather than to take refuge in extreme political ideologies.

A substantial part of the burden fell also on banknote holders in general, and on the public utilities operated by the State or by local Government authorities (railways, post office, electricity, gas and water distribution). Finally, employees in the higher income groups, such as Government officials and white collar and skilled workers, underwent a weakening of their relative position, since their earnings were pushed closer and closer to the levels of unskilled workers' wages.

The distortion in the price and income pattern has been gradually corrected in the decade following the 1947 stabilization, though in some instances (such as that of house rents) the process is not complete, and certain features from the war and early post-war period (such as the relative improvement in the pay of manual labourers) have been incorporated into the new pattern.

materials kept down the demand for credit and the utilization of existing balances at the banks.

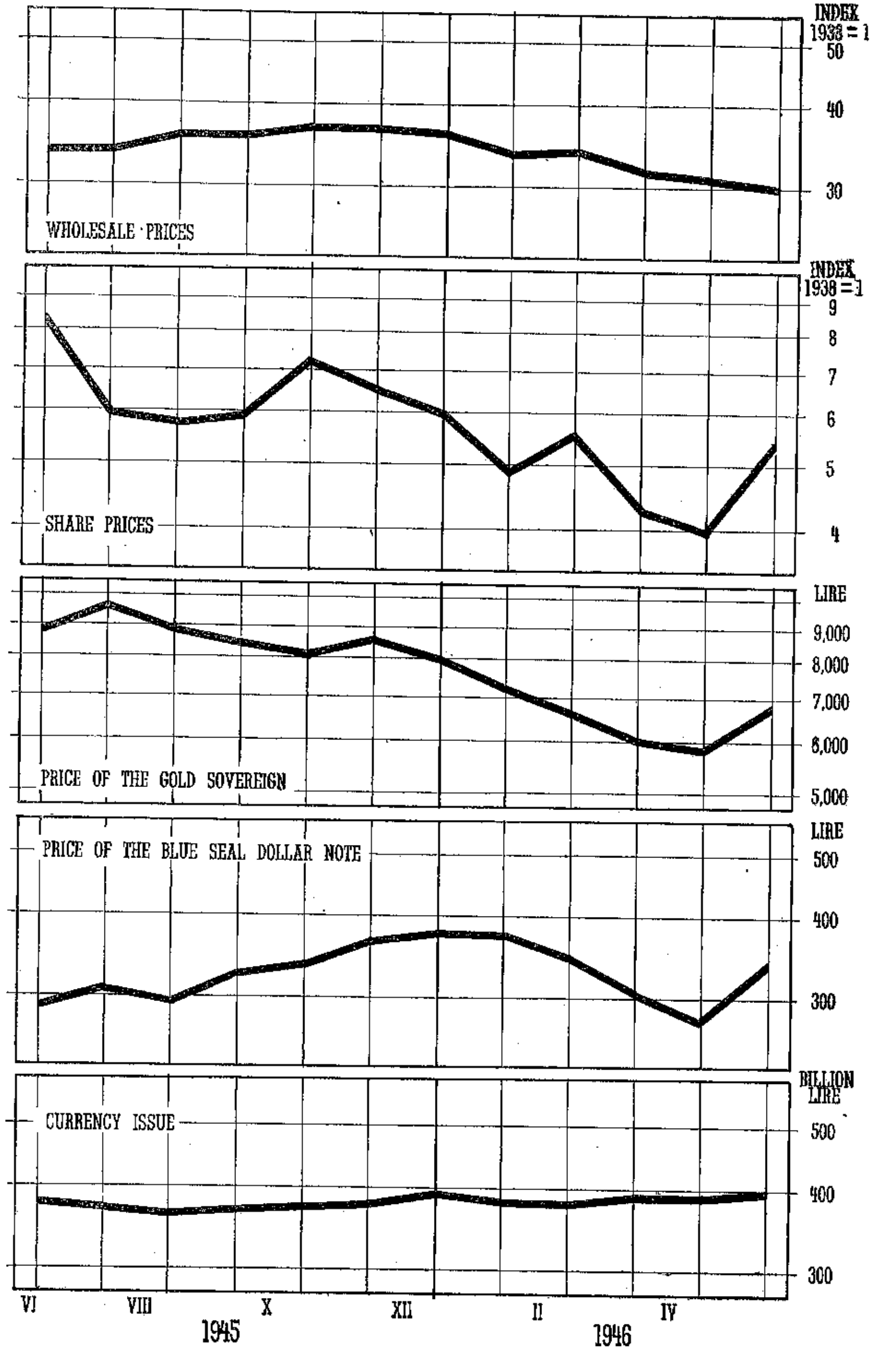
The process of new liquidity formation continued at a moderate pace, with a shift back from the holding of currency to that of deposits. A point of inflexion corresponding to the liberation of the North appears in the curve describing currency circulation (Chart 2). The latter had been increasing at a rate of approximately 4% per month from the beginning of the war to the Armistice. After the uncontrolled expansion that took place under the two occupation regimes, the curve tended to rejoin — in the first year following the liberation — the trend line representing the war-time movement and, having reached that line towards the middle of 1946, proceeding along it up to the end of 1947.

The shift from notes to deposits following the liberation heightened the credit expansion potential. First, for the time being, it allowed banks further to increase their deposits with the central bank (from 120 billion lire in May 1945 to 138 billion in January 1946). Then, when expansion became actual, it reduced the drain of currency into circulation (14).

The confident attitude of the public was reflected in the prices of "refuge" goods and financial assets, such as gold, foreign exchange and shares. In contrast to the conditions which ruled on the labour and commodity markets, and which have already been described, the prices of "refuge" goods in the first half of 1945 were higher in the occupied North than in the liberated South and Centre. In April 1945, the gold sovereign sold for 9,500 lire in Rome and for 11,500 in Milan. On the Milan stock exchange share prices

(14) However, this second effect was damped down by cyclical movements in the ratio of currency to deposit holdings, since the shift to the latter, while continuing in later years up to the present time (see Chart 2), was interrupted or temporarily reversed during inflationary revivals (1946/1947, Korea). The changes in the pattern of liquidity holdings of the public, and their effect on the extent of credit expansion in Italy during the period under review, have been described by GAMBINO ("La ricostruzione dei depositi bancari in Italia", *Moneta e Credito*, No. 24 of 1953, and "Money Supply and Interest Rate in Recent Macro-Economic Conceptions", *Banca Nazionale del Lavoro Quarterly Review*, No. 30 of September 1954). GAMBINO points out another important factor in the process of credit expansion, namely the gradual contraction in the ratio of voluntary cash holdings of the banks to deposits. The role played by cyclical changes in the composition of the money supply has been stressed by the present writer ("Monetary Analysis in Italy", *Staff Papers* of the International Monetary Fund, February 1957), and, with respect to the 1946/1947 experience, by F. A. and V. C. LUTZ, *Monetary and Foreign Exchange Policy in Italy*, Princeton University Press, 1950.

CHART 4 - THE 1945/1946 PAUSE IN INFLATION



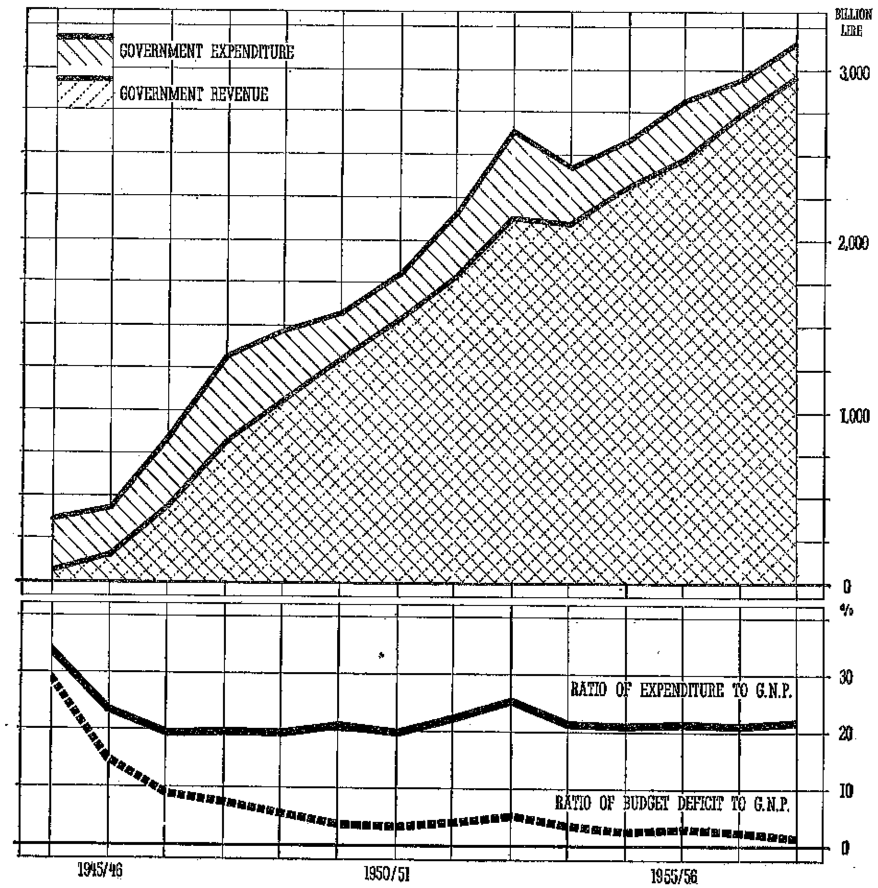
were about one third above the Rome quotations in the autumn of 1944. In the following months, however, when liberation seemed to be near, a downward trend set in and lasted right up till the end of 1945. The average of share prices on the Milan exchange fell from nearly 1,100 in December 1944 (1938 = 100) to about 800 in June 1945, and reached a minimum of 390 in April 1946. Government securities, on the other hand, appreciated; and their average yield declined from 6.28% in May 1945 to a minimum of 5.52%, also in April 1946. Textiles, which had been hoarded at the time of the flight into real values, also fell in price towards the end of 1945.

12. The first loan issue made by the democratic Government was highly successful. It consisted of Five Year 5% Bonds, and was named after Signor Soleri, then Minister of the Treasury. The issue was offered in two stages: first in the liberated regions of the Centre and the South (April-May 1945), and then in the North (July-August). The loan was placed with some 2 million subscribers, and brought in 33 billion lire in the first stage and 76 billion in the second. In the 1945/1946 fiscal year, the Treasury obtained another 83 billions from the issue of Treasury Notes and 51 billions from Post Office Savings. By all relevant standards, these were large figures; they made it possible for Government expenditure in the first post-liberation fiscal year to be financed without recourse to central bank credit.

The budget position at the time was helped, on the expenditure side, by the reduction which the inflation had brought about in the real burden of the public debt and of the salary payments to Government employees. Military outlays, and appropriations for the colonial territories, had also figured significantly in the prewar budgets, accounting, together with interest on the public debt, for 61% of total expenditure in the last peace-time fiscal year (1938/1939). Little of this was left after the war. Receipts were, however, also seriously cut by a number of factors: the disorder of the financial administration, which prevented an up-to-date assessment of tax liabilities; the virtual stoppage of private import trade; the low income levels; and the fall in the consumption of luxury goods subject to excise taxes. New burdens were added to the expenditure side by the bread subsidy, and by the commitments

for completing demobilization, for rendering assistance to veterans and refugees and for initiating payments on war damage indemnities. The ratio of current revenue to current expenditure was as low as 0.18 in the fiscal year 1944/1945. It rose to 0.37 in 1945/1946

CHART 5 - THE BUDGET POSITION, 1944/1945 to 1957/1958



and to 0.54 in 1946/1947 (15). The ratio of the cash deficit to the national product shrank during these three fiscal years from 29 to 15 and 9 per cent (Chart 5).

(15) Cash account figures have been used, and certain expenditures of a non-capital nature which official accounts include in the "capital movement" section of the budget have been transferred to the current section.

13. Two of Italy's most respected statesmen, Minister of the Treasury Soleri and Governor of the Bank of Italy Einaudi, were in the position of being able to exercise a certain control over the volume of Government expenditure and borrowing. Both were austere men in the great liberal tradition of Piedmont. Soleri succumbed to illness in the summer of 1945 while campaigning for his loan. He was followed at the Treasury by two Ministers in the same political line as his. Einaudi remained as Governor at the Bank of Italy until he was raised to the position of Deputy Prime Minister in May 1947, and to that of President of the Republic a year later.

The Treasury Minister and the Governor, working in close agreement, had to fight out the basic issues with Cabinet members who were inclined to other views. In the post-war period Italy's Governments were formed up till May 1947 by centre parties in coalition with left wing parties, and thereafter by centre and slightly left of centre parties. In December 1945, the leader of the Christian-Democratic party, De Gasperi, took over from the Resistance leader, Parri, the office of Prime Minister, which he was to maintain uninterruptedly to August 1953. He has been succeeded since then by other men of his own party. During the whole period, the departments dealing with social affairs and taxation have generally been placed under the guidance of men alive to the duties of the welfare state, while the responsibility for keeping a watch over expenditures has been entrusted to men inclined to greater severity. In fact, since its occupation by the three Liberals (Soleri, Ricci, Corbino), the office of Minister of the Treasury has so far been held — with possibly one exception — by a succession of Demo-Christian politicians (and one independent expert) of conservative outlook.

In the first years of democratic rule (with Communist participation) this division of functions failed to work as an equilibrating system of checks and balances built inside the Government. Instead, it produced a shaky policy line, in which sectorial policy directions came largely to depend on the particular leanings of the responsible Cabinet ministers, ranging from *laisser faire* tendencies to pronounced *dirigisme*. Leadership was not unified, and it was apparently influenced more by preconceived ideas and political interests than by consciousness of the real needs of the moment. Hence the

irregular pace — marked by sudden decisions and equally abrupt reversals — of governmental action.

The weaknesses of economic policy, in the period leading up to the De Gasperi-Einaudi Government of May 1947, were particularly conspicuous in relation to three sets of problems — those of regulating the stock market (No. 14), of controlling the prices of foodstuffs (No. 15) and of imposing a capital levy (No. 16). The unsatisfactory treatment of these contributed to the 1946/1947 revival of inflation.

14. The heavy depreciation of the currency which had already taken place by the time of Mussolini's fall (July 1943) made it seem appropriate to abandon pre-war reference values in matters of taxation. Accordingly, the Badoglio Government started to revise the relevant Fascist legislation, which had been rendered obsolete by the great inflation of the succeeding nineteen months. The destruction of the dams against open inflation that had been erected by Count di Revel proceeded slowly, in the liberated part of the country, between the summer of 1943 and the spring of 1945. It was resumed with real zest and completed a year later by Minister Corbino, who concentrated his efforts on the task of lightening the burdens on security investments and of generally freeing stock exchange activity.

The main steps will be recalled here, in rough chronological order. Among the first (August 1943) were: an adjustment to take account of the new price level of the tax on capital gains deriving from sales of securities and real estate; and the repeal of the obligation for purchasers of shares to invest an equal amount in Government securities. In 1944, the limit below which company profits were exempt from the war profits tax was raised; the war-time addition to the sales tax was suppressed; and the special tax on dividends was reduced from 25 to 10 per cent. In 1945, the progressive tax on real estate and securities transactions (a tax which had been retained in August 1943) was replaced by a flat rate. In 1946, the special tax on income from securities, the war profits tax, the surtax on transactions in securities, and the limitation on dividend distribution, were all abolished. Increased depreciation allowances were admitted on the basis of a revaluation of income to allow for the rise in the price level; and the transfer of revaluation profits to capital account was permitted. The turnover tax on security transactions was halved and thus brought back to its 1938 level. Only one important piece of war-time legislation, the compulsory registration of shares in the name of the owner, survived. (It is still with us, and as hotly debated as ever).

These measures were a strong stimulus to the revival of investment in industrial securities and, given the extreme liquidity of the market, they resulted in a sharp upturn in share quotations. Many companies took advantage of the newly granted freedom to revalue their assets and split their shares. In the euphoric atmosphere that followed, the average of share prices rose, in the four months between the end of April and the end of August 1946, to two and a half times the initial level. The Government then reconsidered its policies and decreed the confiscation in favour of the Treasury of 25% of the capital gains realized through the revaluation of physical assets, thus applying for a few weeks a brake on the price rise. After the resignation of the author of this last measure (Corbino), and the resumption by the Government of the plan to extend the capital levy to all forms of liquid wealth (banknotes, deposits, fixed-interest bearing securities) not registered in the name of the owner, share prices resumed their upward trend under the influence of widespread speculative trading. In April-May 1947, the average price level of shares was 6 to 7 times what it had been in the spring of 1946; and the yield had fallen to about 0.30%. Meanwhile the Government had reintroduced, at the beginning of April, the surtax on security transactions, at the rate of 4%. The month of May saw a reversal of the trend; and by the end of the year share prices stood at a level which was about one quarter of the spring peaks.

15. The stricter enforcement of price controls on basic agricultural commodities (wheat, corn, rice) had resulted in a distortion of the pattern of production; for the peasants had been encouraged by the possibility of evading the respective controls to give more attention to the less essential produce (vegetables and livestock). A more balanced price structure was needed if production was to resume its former, socially more desirable, pattern. Accordingly, in May 1946 the official prices for the 1946 crops were increased threefold above those of the preceding year. Their prices thus stood at 20 to 22 times above the levels of 1938. In the case of soft wheat, for example, as against an official 1938/1939 price of 135 lire, the 1945/1946 price was 750 lire and the 1946/1947 price 2,250. The average price received by producers for both soft and hard wheat turned over to the Government purchasing authority was 2,700 lire per 100 kilograms. The price at which the Government-purchased wheat was sold to the mills was, however, left unchanged, with a view to avoiding an increase in the price of bread: the Government thus had to shoulder the difference of 1,600 lire between the new price and the old one (1,100). When the expenses incurred by the Government for operating the purchasing programme and for transporting the wheat to the mills were added to the price differential just mentioned, the result was a loss to the Treasury approximately equal to the entire price paid to the producers. This meant that the proceeds from the sale of bread covered only the storage, distribution, milling and baking costs. As the banks that financed the purchasing programme could and did discount the relevant paper at the central bank, the Treasury's losses were made good by adding to money in circulation. Market expectations reacted sharply to the pushing up of official wheat prices. It had become evident that the Government had abandoned the idea of stabilizing the general price level at the positions held by the controlled prices of essential commodities and public utility services, prices which until May 1946 had not exceeded the 1938 level by more than 7 or 8 times.

16. Plans for a currency reform had been considered before the liberation of the North. The intention behind them had been not so much that of absorbing the excess of liquidity or imposing a general capital levy, as that of providing against the possibility that the Germans might print Italian currency in their home land with equipment taken away in a possible retreat from Italy — should such a retreat be followed by continuing armed resistance in the Alps. In such an event, banknotes circulating in Italy at the moment of the liberation would have had to be stamped. Negotiations took place with the Allied officials with a view to having the notes printed in the United States, but they ended in disagreement over delivery periods and cost. Meanwhile, the North was liberated. The collapse of Germany followed shortly afterwards, and only the problems of excess liquidity and of the capital levy remained real.

Soleri was unfavourably inclined towards " tampering with money ", and his second successor at the Treasury was an outspoken opponent of the monetary purge.

A panel of economic experts appointed by Soleri had previously pronounced itself against a currency reform. However, the representatives of the left wing parties in the Government succeeded in keeping the issue alive. In the end it was resolved not so much by a deliberate policy choice, as by delays in the supply of notes and by other unexpected obstacles, which gave time for a resumption of inflation, making the purge socially indefensible.

Shortly after the liberation of the North, an effort was made to pool the equipment existing there and in Rome. The Bank of Italy's printing plants, which had been transferred to the Abruzzi during the war, had been wrecked by the retreating Germans and were now being retransferred to Rome. This situation created the necessity for making use, to some extent, of Government and privately owned paper mills and printing plants. The plan was now to produce the new notes in Italy.

By April 1946, the stock of new notes was sufficient (but only barely so) for the substitution to be carried out. At this time, however, the Ministry of the Interior, which would have had to supervise the operation from the point of view of the maintenance of order and the supply of transportation, was busy preparing the " referendum " of June 2, 1946, which resulted in the end of the Monarchy.

The discovery, in June, that workers in one of the private plants had succeeded in smuggling out copies of the original films used in the lithographic process of printing the notes rendered part of the accumulated stocks unusable and compelled the authorities to study a different type of banknote.

At the end of 1946 the " Reconstruction Loan " was floated; the bonds were redeemable in 30 years and bore interest at the rate of 3½ per cent per annum. This rate was unusually low for the Italian market, where a yield of 6% on long-term securities is considered normal. The bonds carried, however, a special privilege: that of exemption from the extraordinary capital levy that was being studied at the time. The terms of the loan could thus be explained only in the light of the projected levy on all forms of wealth held as liquid assets, i.e., banknotes, bank deposits and Government securities.

The diversity of the political views of the parties then in power (among them the Communist party, represented by the Finance Minister) was responsible for the coming into being of the peculiar case of a borrowing operation linked in the present to a tax measure which was still undefined and still impracticable in the form planned because of the inadequacy of the supply of new-type banknotes.

A year and a half had now passed since the liberation of the North, and during the last six months the inflationary process had resumed its course. Its liquidity-reducing effect, and its repercussions on the distribution of income and of accumulated wealth, made the plan to tax away war profits and profits realized in the preceding inflationary wave and held in liquid form appear purposeless. Inflation had practically wiped out the purchasing power of assets with a fixed money value, i.e. banknotes, savings deposits, and fixed-interest bearing securities. A form of taxation which further hit such money claims would only have aggravated the injustice in the distribution of wealth that it was designed to correct.

Last but not least, the expectation of the currency reform intensified the flight into goods. That is to say, it added a psychological factor to the already numerous objective causes of inflationary pressure operating in the Italian economy, such as the Government's budget deficit and the expenditure of accumulated liquid funds on reconstruction projects.

In such circumstances, the abandonment of the plan for a currency reform appears to have been a wise decision. It was adopted by the third De Gasperi Government, formed at the beginning of February 1947, in which the direction of both the Ministry of Finance and the Ministry of the Treasury was unified in the hands of a Christian-Democrat, Campilli.

The law imposing the extraordinary capital levy, enacted at the end of March, did not attempt to provide for direct assessment of the tax liability with respect to liquid assets. Instead, the tax due on other forms of personal and corporate wealth (real estate, shares, personal credits) was increased by a fixed percentage to allow for presumed holdings of liquid assets.

The form which the capital levy thus finally took deprived of most of its value the specific exemption granted to the purchasers of the Reconstruction Loan Bonds. Consequently, in April, the Government offered holders the option of converting these bonds into new 5% securities — without additional payments, of course.

The price of the bonds not presented for conversion — they had been issued at 97.50 lire per 100 lire of nominal value — fell rapidly, reaching a minimum of 65 lire in December 1947.

17. The three previous sections are not intended to give a full account of the policies and the market forces making for inflation in 1946/1947. Their aim is merely to draw attention to certain elements in the situation which perhaps have not received, in the accounts given by other authors, attention commensurate to the role they played in inflating the volume of demand through the use of existing liquidity balances and the expansion of central bank credit.

The emphasis in previous works (16) was laid on other and equally important causal factors, including structural weaknesses and maladjustments in the economic system, foreign exchange policies (No. 18), and the effects of the sliding scale of wages (No. 19).

Price inflation developed while the economic system was still far from having achieved full employment of labour. Industrial production more than doubled in the eighteen months from March 1946 to September 1947. The increase did not, however, appreciably reduce the numbers of the unemployed, owing to the redundancy of part of the labour already on the pay-rolls.

In so far as the unemployment was due to a generalized shortage of *capital*, depressing the productivity of a large mass of labour below the wage rates imposed by the trade unions, or to the inflexibility of factor proportions (notably in relation to land), it was structural in nature and could not be absorbed by expanding demand (17).

Low elasticity of supply made for increasing prices of farm products. In individual branches of manufacturing industry, expansion was held back by shortages of imported raw materials, fuel and power, shortages which manifested themselves before the full employment of existing capacity was reached. Steel production

(16) These include B. Foa, *Monetary Reconstruction in Italy*, The Carnegie Endowment for International Peace, New York, 1949; F. A. and V. C. Lutz, *op. cit.*; E. S. Simpson, " Inflation, Deflation and Employment in Italy ", *The Review of Economic Studies*, 1949/1950, No. 44; A. O. Hirschman, " Inflation and Deflation in Italy ", *The American Economic Review*, September 1948, No. 4; Bank for International Settlements, *Italy's Economic and Financial Position in the Summer of 1947*; W. D. Grampp, " The Italian Lira, 1938-1945 ", *The Journal of Political Economy*, August 1946, No. 4.

(17) A penetrating analysis of these factors is made by Simpson, *op. cit.*

capacity had been reduced by air attacks and the dismantlement of plant by the retreating Germans; and a shortage developed. In the special case of the engineering industries, which had been expanded to serve war needs, excess capacity was due to lack of demand, or rather to lack of adaptation to the newly emerging pattern of demand; however, in several cases reconversion to peace time production was strikingly successful.

18. A major development in foreign exchange policy was the permission given to exporters, in April 1946, to dispose of one half of their export proceeds, within a time limit of three months from their acquisition, on a free market, at a floating rate that would match the supply of foreign exchange with the demand deriving from imports of certain listed goods. The sale on the market was limited to the so-called " free currencies ", i.e. dollars, pounds sterling and Swiss francs. The double rate system has been criticised by Foa (*op. cit.*) as inducing a considerable degree of exchange depreciation and affecting expectations so as to " bring about further increases in domestic prices, almost irrespective of whether the commodities affected by those price increases entered the international market ". The system also brought about distortions in trade flows, since it did not apply to bilateral agreement currencies. In addition, it offered a legal way of hedging against the depreciation of the lira by retaining export proceeds for 90 days.

The depreciation of the lira on this market was indeed fast. The legal free rate for the dollar shot up to about 600 lire in September, 1946, as against an official rate of 225. The climb was checked by subjecting to licence, for a time, imports of cotton and wool, which were partly financed on the free market. It was, however, resumed in February 1947 and continued to an all time high of over 900 lire to the dollar in May.

It should be granted to the critics of the system that, with a single rate, the climb would have been less steep. On the other hand, the dual exchange rate system fitted in with the dual price system which prevailed at the time. The average ratio of free and black market prices to official prices of commodities was still as high as 3.6 in December 1946 (18). The 50 per cent of export proceeds which had to be surrendered at the official rate to the exchange

(18) *Bank of Italy Report for 1947*, pages 97-107.

control authorities served to finance imports by the Government of "essential" goods, for sale at official prices. The official exchange rate was also used to calculate the lira selling price from the landed cost of imports under official aid programmes. Altogether, 71 per cent of total payments for imports in 1946 and 45 per cent in 1947 were settled at the official rate.

The adoption of a single free exchange rate as early as 1946 would have implied the widespread removal of price controls, or the setting up of an overt system of import subsidies and export taxes. Political expediency ruled out mass transfers of income from the consumers to the propertied classes and to the public utilities which the first course would have implied; while the second course would have asked too much of a weakened bureaucracy. The shackles which had bound it for so long now gave the economy a limping gait.

19. It was noticed previously (No. 9) that in the spring of 1945 the wage level in the liberated regions was much higher than in the North (Chart 6). In these circumstances, it would have been too ambitious a task to try, once the North was liberated, to align the price level for the whole country with that at which a large section of the price system had been held by controls in the North. A stabilization at, say, ten times the pre-war level would have been inconsistent with the level of wage-costs which had been reached in the South and which was practically irreducible. On the other hand, no established rigidities would have stood in the way of an attempt to halt prices at a somewhat higher level, perhaps around 20 times pre-war.

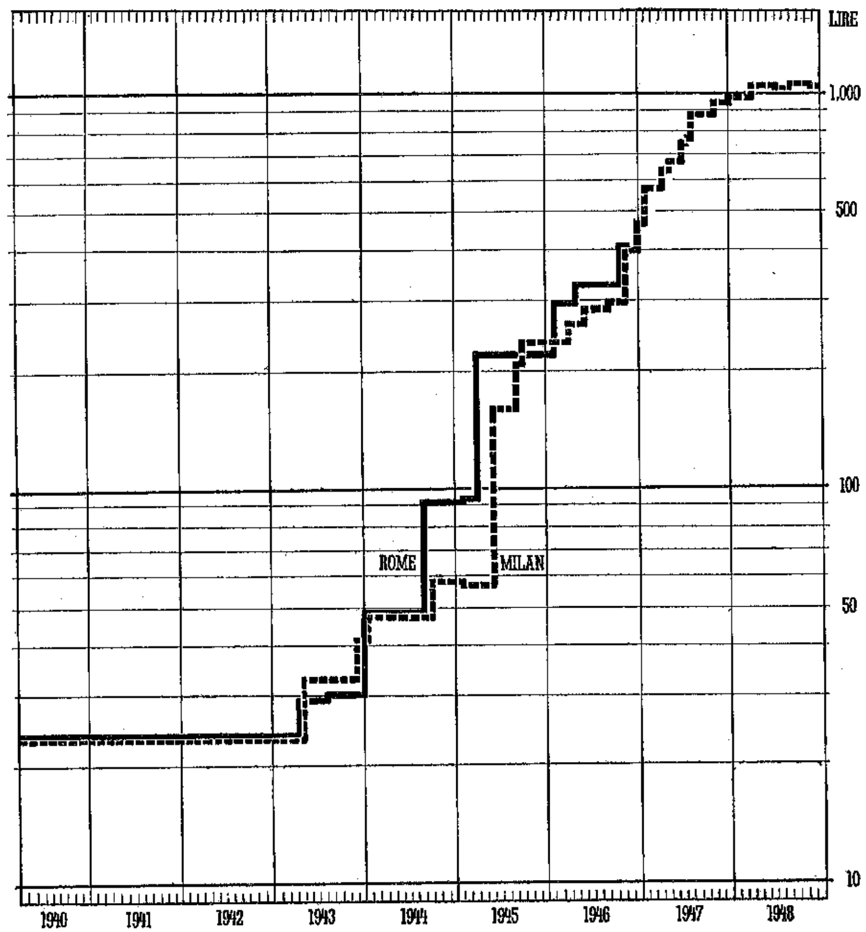
Unfortunately, in addition to the inflationary factors just recorded (Nos. 15-18), the upward push of wages was continued, after the liberation of the North, through autonomous increases and later through the operation of the sliding scale.

The contingency allowance, which had been introduced in March 1945 in the South and Centre, was extended in June to the recently liberated North. Its effect was to raise the pre-existing pay levels by amounts ranging from about 40 per cent for the higher paid office worker, to 170 per cent for the male manual labourer and 200 per cent for the female worker.

Autonomous increases in basic rates of pay followed in the autumn. In December, the contingency allowance was tied to the cost of living: the adjustments were to take place quarterly.

In October 1946, it was stipulated that the adjustment would be made every other month and, for the case of a fall in the cost

CHART 6 - DAILY PAY OF AN UNSKILLED WAGE EARNER IN INDUSTRY, 1940 to 1948



of living, a "buffer region" was provided, up to a decline of 8% in the index, within which the cost of living allowance would remain unchanged; while a drop in the cost of living index going beyond the 8 per cent limit was to be accompanied by a less than proportional reduction in the allowance. The wage level in the North was brought into line with the higher one prevailing in Central and Southern Italy; and a national system of wage negotiation was reestablished.

At this time, the nominal wage of a skilled worker was from 15 to 20 times the 1938 level; for women and other lower paid workers the ratio was roughly twice as high.

The process of adjusting wages upwards under conditions of a rapid depreciation of the currency gave rise to incessant labour disputes, which in the inflamed atmosphere of those years often assumed a political character and led to frequent outbursts of violence on the part of the unions. Industrial firms were at the same time prevented from dismissing surplus labour by Government regulations, which had been issued by the Fascist administration in the German-occupied regions in order to avoid the creation of pools of unemployed workers who might joint the underground movement. On the other hand, firms had hired workers and clerical staff in excess of their needs so as to protect them from forced enrolment in the German labour organisations in Italy or in Germany. The thus inflated payrolls had to be financed out of the proceeds of industrial production running, in the second half of 1945, at about one third of the pre-war level.

Industry did, however, benefit from the removal of the price controls on manufactured articles, while electric power and transportation rates together with other important cost elements remained at the lower controlled levels. It was also helped by the lightening of the debt burden in consequence of the inflation. In spite, however, of these compensatory factors, not only public utilities, but also other important productive sectors that were relatively free from controls — the mechanical engineering industries, among others — operated in the red in the months following the liberation. Some relief to financial stringency was provided by the liquid balances which had been accumulated during the war as a result of the disposal of stocks, and the low volume of reinvestment of depreciation allowances in the upkeep of production facilities. In the mechanical engineering industries, where the difficulties were magnified by the problem of reconversion to peace-time production, large financial aid from the Government was necessary and forthcoming. Cost inflation generated a high demand for ordinary banking accommodation, since wage bills were constantly running ahead of proceeds from sales (19).

20. The new downward slide of the lira (Chart 7) started in May 1946, with a rise in the prices of shares and of foreign currencies. Two months later, consumer goods prices joined the upward movement, reflecting the same trend as was set going in the United States by the abolition of wartime controls (20). Until the month of September, however, the commercial banks' balances at the central bank expanded further, even though their real value continually declined. Towards the end of the year, the effects of the Reconstruction Loan, of the seasonal needs of trade, and of a sharp wage increase of over 20% between October and December, all combined to reduce such balances. They fell by one third — from 150 billion to about 100 billion lire — in the course of three months.

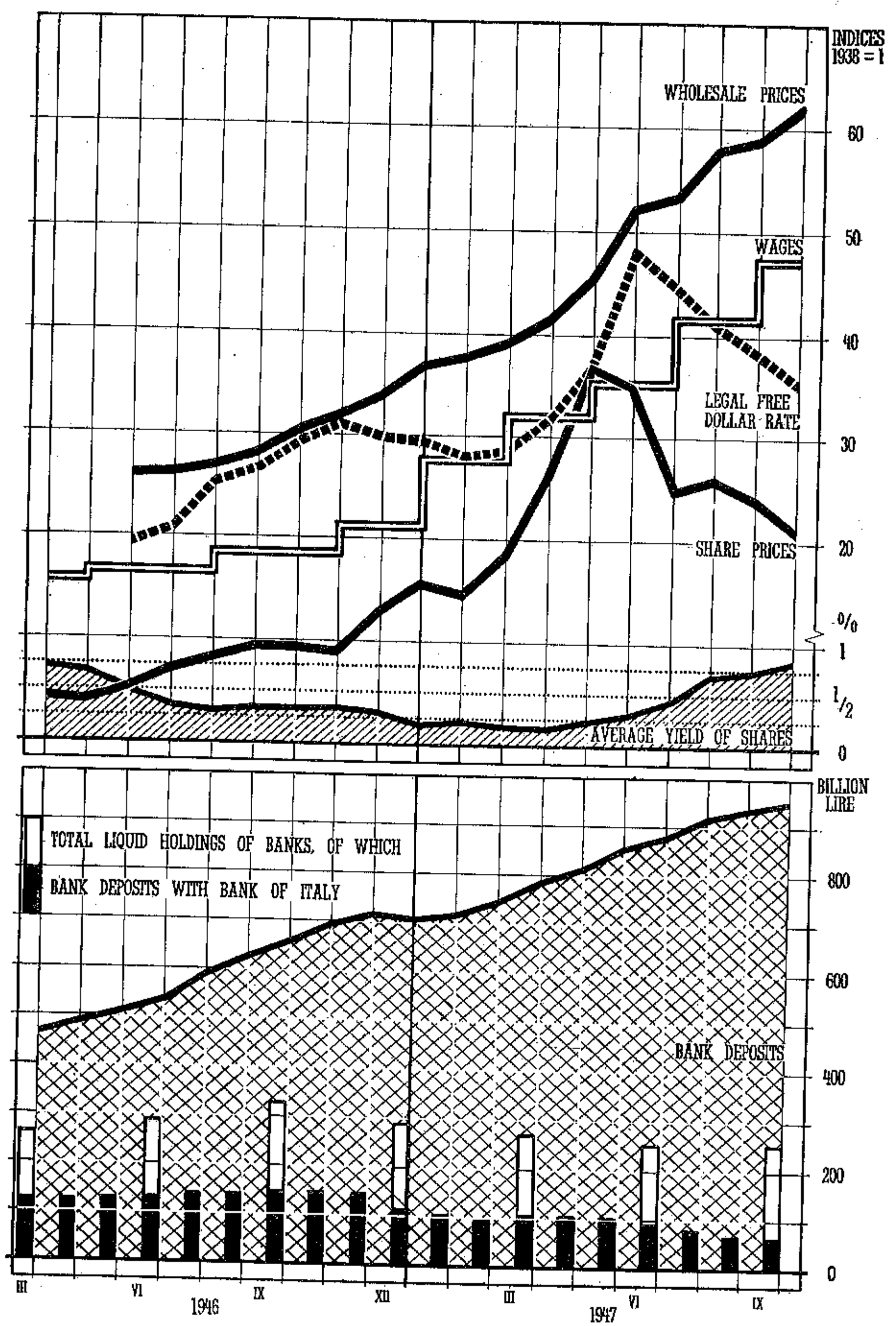
In the early months of 1947, the Bank of Italy tried to call back to life an old regulation establishing a maximum ratio of deposits (and therefore of loans) to the banks' capital, a regulation which had become obsolete as a result of the war-time expansion in deposits. But the central bank's plea that the old rule should be observed was too remote from present day realities, and the banks took little notice of it. The process of credit expansion continued unabated. It was ascribable partly to price increases and speculative stocking of goods, and partly to the expansion in imports (financed out of UNRRA aid and export proceeds) and in production levels — two developments acting, of course, as relieving factors from the supply side.

21. At the beginning of June 1947, the fourth De Gasperi Cabinet, the first in the postwar period without Communist participation, was formed. The Governor of the Bank of Italy, Einaudi, entered the Cabinet as Deputy Premier and Minister of the Budget. He was assisted by Professor Del Vecchio, also an outstanding eco-

(19) Government funds and guarantees for the finance of reconversion were provided by *ad hoc* measures adopted in November 1944 and May 1946. These were followed, in September 1947, by the establishment of a 55 billion lire Government fund to finance the mechanical engineering industries.

(20) The Department of Labor index of raw material prices (1929=100) rose from 138.2 in 1946 to 169.8 in 1947; the similar official British index (1938=100) from 221 to 280. Reuter's index (18 September 1931=100) moved from 264 in the first week of May 1946 to 337 at end of September 1947.

CHART 7 - THE 1946/1947 INFLATION WAVE



nomist, as Minister of the Treasury. The announcement of the financial programme of the new Government accelerated tha fall in stock exchange and foreign currency prices which had started some weeks earlier. The new Government revived the Ministers' Committee in charge of the supervision of credit policies, created by the Banking Law of 1936. At its first meeting, the Committee decided to introduce a new system of reserve requirements for the commercial banks. The decision was made known to the banks at the end of August and become effective on September 30.

The monetary picture, at the time of this decision, was patchy. The liquidity position was growing tight. Central bank credit had not been expanded so fast as to offset the drain of excess bank liquidity into the currency circulation. However, the buoyancy of commodity prices continued. The blackest spot was the drain on the small reserve of foreign exchange which had been accumulated in the second half of 1946. The country had run out of dollars (21); it still held substantial sterling balances, but the British currency had relapsed into inconvertibility on August 20, and several basic dollar-area supplies (such as coal, cotton, oil, wheat) could not be obtained in sufficient amounts from sterling-area sources. The prospect of an exchange crisis in the near future strengthened the Italian authorities' determination to force a change of climate by strictly applying the new discipline (22).

The success which they had in reversing the trend of prices was aided by the taut liquidity and other conditions which had gradually developed in the economic system, while the inflationary wave ran its course. These conditions will be considered as a whole in the next section.

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(21) On the occasion of a lecture given before the Political Economy Association of Zurich in February 1956, the present Governor of the Bank of Italy, Menichella (who in 1947 held the office of Director General of the Bank and since the entrance of Einaudi in the Cabinet was acting Governor) made it known that during the Annual Conference of the Governors of the Bretton Woods Fund and Bank that took place in London in September 1947, Einaudi and himself informed their American colleagues, Snyder and Clayton, of the impending foreign exchange crisis in Italy. The two American officials could not help stressing that the appropriation of Marshall Aid by Congress would require a few more months.

(22) The new reserve requirements were tailored to the then existing liquidity position of the banks, so as to tie up at the start as statutory reserves an amount (112 billion lire) almost equal to that (115 billions) held by the banks in the form of liquid balances and eligible securities deposited with the Bank of Italy and the Treasury.

The requirements were as follows: each bank was allowed to dispose freely of deposits up to 10 times its capital and had to deposit initially with the Bank of Italy cash or Govern-

22. Short-term credit transactions during the 1946/1947 rekindling of inflation, and the related changes in the money supply and other liquidity holdings, are shown on the left-hand side of Table 5. The table describes the transactions of the Bank of Italy, and of the other banks taken as a single group, with each other and with three economic sectors: (1) the Government; (2) the business and personal sector, inclusive of local authorities and publicly owned enterprises, for which no separate data were available; and (3) foreign countries.

In reading the table, it may be useful to keep in mind the following points: (a) Gross foreign exchange holdings are taken net of "*loro* account" credit balances of foreign banks; other lire holdings of foreigners may be assumed to have been at the time practically nil. (b) Government borrowing from the banking system is net of Government owned deposits (changes in which, however, are shown separately). (c) Transactions between the central bank and other banks (also shown separately) cancel out for the system as a whole. As a result of (a), (b) and (c) the expansion in the assets total of the banking system is matched by an equivalent expansion in the liquidity holdings of the business and personal sector.

The data in the table are arranged to show the change in bank assets in the first row of totals (Columns 2 and 3), and the related changes in liquidity holdings underneath. Current accounts and other deposits (included under secondary liquidities) are shown where they belong, i.e. as being held either with the Bank of Italy or with the "other banks". The attribution of the expansion in currency held outside the banking system to central bank or other banks' transactions respectively implied an arbitrary, though minor, assumption. That is to say, the whole of the currency issued by

---

ment securities to the amount of either (1) 20% of deposits over and above the free quota, or (2) 15% of total deposits, whichever was the lower. The reference date was September 30, 1947.

A 40% reserve had to be set aside against any increase of deposits occurring after this date, but an upper limit to the compulsory reserve was set by an overall 25% reserve-deposits ratio.

Since that limit has now been reached by almost all the banks, it may be said that the actual reserve ratio is today 25% of deposits. No distinction is made between demand deposits and time or savings deposits so far as the reserve requirements are concerned, but ordinary savings banks, which receive almost exclusively time and savings deposits, were exempt from the requirements until October 1958, when future *increments* in their deposits were subjected to a special reserve obligation.

the Bank of Italy was treated as going to the business and personal sector (as distinguished from the banks); and the expansion in the cash balances of the banks was counted in the "other banks" column as a negative item.

Not only the banking system, but also the Treasury creates liquidity. It does so both as an issuer of currency and as an issuer of Treasury Notes. The liquidity creation by the Treasury is shown in Column 4. The column also records as Treasury-created liquidity the balances deposited on current account at the Post Offices, balances which are available to the Treasury.

It was mentioned before that drawings by the Government and the banks on deposit balances held by them at the Bank of Italy are shown separately from borrowing transactions. Among these latter transactions, the discount of wheat bills is also shown separately. The reason for making these distinctions lies in the different degree of control that the central bank can exercise in the various cases. The disposal over credit balances has at no time been subject to limitations, except in an indirect way through the establishment of statutory reserve ratios. The ineffectiveness of the central bank's attempt to smother the inflationary flare-up of 1946/1947 was to some extent due to its lack of control over such balances.

Again, the central bank had practically no power of refusing the rediscount of bills originating from the financing of the Government-sponsored system for the collection of wheat and certain other crops, which was part of the mechanism first of rationing, then of food subsidies. Losses incurred by the collecting system (*ammassi*) were a charge on the Government. Since the accumulated losses incurred by the Government on this account were higher at the two ends-of-period (September 1947 and December 1948) than the amounts of rediscounted bills outstanding at those dates, it has seemed appropriate to treat the whole amount rediscounted as a direct claim of the central bank on the Government. To Government borrowing proper, a statutory limit applied.

Lending to the banks could be more effectively checked, since the central bank is not committed to accepting Government securities as collateral for advances, nor to providing automatic rediscount facilities for eligible bills (except for the loophole of the wheat bills). However, once a deposit of eligible securities has been established at the Bank of Italy as collateral for advances which the owner may

TABLE 5

CHANGES IN HOLDINGS OF LIQUID ASSETS AND THEIR SOURCE (1)

(Billions of lire)

Transactions		July 1946 to September 1947					October 1947 to December 1948					
		Banking system		Economic sectors			Banking system		Economic sectors			
		Bank of Italy	Other banks	Government	Business and persons (a)	Foreign countries	Bank of Italy	Other banks	Government	Business and persons (a)	Foreign countries	
(1)		(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	
Acquisition of foreign exchange by B. of I. and Exchange Office		—				—	161.6				*161.6*	
Extension of B. of I. credit to other banks		36.6	*36.6*				26.6	*26.6*				
Discounts of wheat bills by B. of I.		66,5		66.5			30.5		*30.5*			
Statutory reserves held at B. of I. and related investments		*4.0*	4.0				3.3 (b)	143.7	*147.0*			
Other B. of I. loans and investments		54.1		*43.1*	*11.0*		162.4		*146.4*	*16.0*		
Deposits held at B. of I. by other banks and Government		– *115.9*	– 67.3	– 48.6			*31.2*	– 30.4	61.6			
Direct investment of statutory reserves by other banks			7.9	*7.9*				92.9	*92.9*			
Loans and investments by other banks			461.6	*41.5*	*420.1*			402.5	*52.3*	*350.2*		
Banking system as a whole		269.1	369.6	207.6	*431.1*	—	353.2	582.1	*407.5*	*366.2*	*161.6*	
Treasury short-term borrowing from the public				*21.2*					128.9			
Changes in holdings of financial assets by the business and personal sector	Total											Total
money supply												
currency (c)	237.6	*275.8*	– *38.0* (d)	– *0.2*			*295.6*	– *34.0*	—			261.6
current accounts	296.5	– *8.4*	*287.9*	*17.0*(e)			*30.8*	*291.6*	*17.3* (e)			339.7
secondary liquidities	125.8	*1.7*	*119.7*	*4.4*			*26.8*	*324.5*	*111.6*			462.9
all liquid holdings	659.9											1,064.2
other financial assets (f)	236.1											315.6
all recorded assets	896.0											1,379.8

(a) Figures in italics show changes in liabilities of the transactor to which the *column* relates. Local authorities are included with business and persons.
(b) Excess of investment by Bank of Italy over statutory reserves held with it.
(c) Inclusive of circular checks.
(d) Issue of circular checks, net of increase in bank cash. The relevant figures in the two periods are 54.4 and 25.2 billion lire for the issue of circular checks 92.4 and 59.2 billion lire for the increase of bank cash.
(e) Inclusive of deposits on current account at Post Offices.
(f) As from following breakdown:

	Jul. 1946 to Sep. 1947	Oct. 1947 to Dec. 1948
Post Office Savings	58.7	170.9
Long-term Government securities	113.6	3.5
Bonds	9.5	58.8
Shares	54.3	82.4
Total	236.1	315.6

need in the future, such advances will normally be granted when asked for.

Direct transactions by the central bank with the general public and the non-banking institutions are practically limited to acceptance of deposits and the granting of advances on Government securities. The volume of these transactions is small and decreasing.

23. The size and direction of money flows through the main channels, during the inflationary run, followed a rather stable pattern. A new pattern emerged, however, after the introduction of statutory reserves and the reversal of price trends which accompanied it. The contrast is brought out by the comparison of the left-hand side of Table 5, which sets out the figures for the fifteen months preceding the stabilization, with the right-hand side, dealing with a period of equal length following the stabilization (end of September 1947 to end of December 1948). The latter period covers about half the phase of falling prices which developed between the stabilization of September 1947 and the new turning point of mid-1950. That period is also marked by a stable pattern of money flows to and from the central bank.

As the table shows, central bank transactions with the Government and with the banks were both major factors in the expansion of the credit base that marked the pre-stabilization months. New lending played a greater role than drawings on balances in the transactions with the Government, and a smaller one in those with the banks. Total drawings by the Government were 158 billion lire, of which 49 came from deposits. Drawings by the banks were 100 billion, of which 67 were from deposits. Government borrowing, the largest of the four gross flows, mainly took the indirect form of rediscounts of bills to finance the losses of the wheat pools.

The origin of the liquidity holdings of the banks has been discussed previously (Nos. 4 and 5). What remained of the inflationary fuel stocked during the war was now being burnt up. The balances at the disposal of the Government had been built up during the post-liberation lull in the inflationary process; they came from the Soleri loan, from Post Office Savings, and from other borrowing in the market.

Government financing by the banking system fell mainly on the Bank of Italy. The stream of funds flowing from the central

bank was "multiplied" by the other banks (23) in accordance with the usual process of credit creation, to the benefit almost exclusively of the private sector. While the banks added only a moderate amount (41 billion lire) to their investments, they expanded their loans and advances from about 230 billion lire in June 1946 to about 650 in September 1947. Only after the stabilization did the Treasury make larger use of commercial bank facilities and of the capital market.

24. The relapse into open inflation brought with it the typical contraction in the ratio of the money supply to the national product, as well as a distortion in the pattern of liquidity holdings. The decline — observable ever since the end of the war — in the note issue component of the money supply came temporarily to a halt. The shift to deposits and secondary liquidities was resumed in the deflationary phase that followed. This is shown by the figures in the lower outside columns of Table 5, when those figures are adjusted for seasonal movements (the largest of which is the end-of-year expansion in the note issue) (24). Calculated from the adjusted figures, the expansion in the note issue, during the fifteen months following the stabilization, works out at 0.85 times the expansion in the previous fifteen months. The corresponding ratio for current accounts was 1.04; for time deposits and other secondary liquidities it was as high as 3.61, also owing to a shift back from long term securities (the Reconstruction Loan) to Treasury Notes in Government borrowing. The ratio for capital market assets was accordingly rather low (1.34), but the movement towards the long-term end of the spectrum of financial asset holdings proceeded further in later years (No. 37).

(23) The term "other banks" or simply "banks" is taken to include ordinary savings banks as well as commercial banks. The term "banking system" is meant to include the central bank as well.

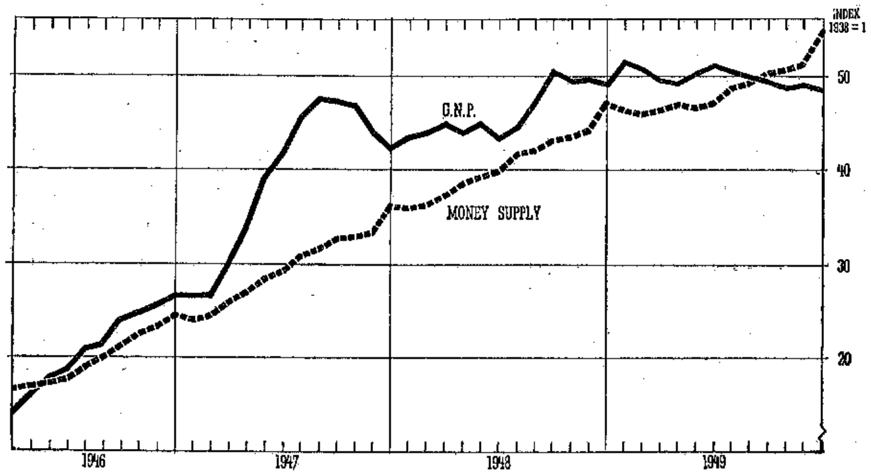
(24) For the coefficients of seasonal adjustment see *Bank of Italy Report for 1954*, p. 358. The seasonally adjusted figures of the increases are as follows (*in billions of lire*):

	Jul. 46 to Sep. 47	Oct. 47 to Dec. 48
Currency	222	188
Current accounts	290	302
Secondary liquidities	124	447

D) Eleven years of stability and growth (1948-1958)

25. By the autumn of 1947, tension had developed in the liquidity position and in the general state of the market. The war-time inflated ratio of the money supply to the national product had moved back to the pre-war level by the spring of 1946; and the ratio steadily declined thereafter, as a result both of price and of production increases. The ratio of loans to deposits at the banks

CHART 8 - THE NATIONAL PRODUCT AND THE MONEY SUPPLY
MARCH 1946 to DECEMBER 1949



rose from 42 per cent in June 1946 to 75 per cent in September 1947. Bank credit had been used to finance the stock exchange boom and to replenish stocks of goods. Again with the unwitting assistance of the banks, export proceeds had been left abroad, in expectation of a rise in the official lira exchange rate, a rise which materialized in November 1947, when the rate for the dollar was increased to 575 lire.

The predisposition of the economy towards deflationary developments showed up in the sharp increase in the demand for liquidity following the reversal of expectations in September, and in the related changes in the money supply and the price level (Charts 8 and 9).

The expansion in the money supply continued at a high, though declining, rate. For currency, the monthly rate of increase contracted from 3.4 per cent in the fifteen inflationary months to 2.3 per cent in the nine months from September 1947 to June 1948, and to 1.4 per cent in the following two years. For current accounts the decline was smaller: during the three periods, the monthly rate of expansion first fell from 4.6 to 3.1 per cent, and then climbed back to 3.4.

The expansion in the volume of bank credit outstanding was slowed, but at no time halted, except possibly in the crucial month of October, 1947.

These movements were attributable to policy actions intended to prevent the development of a cumulative deflationary process, and to the liquidity-creating effect of the net inflow of foreign exchange. An unusually large amount of assistance was given by the central bank to the banks in the last quarter of 1947. The Treasury increased its expenditures to the point of incurring in the fiscal year 1947/1948 the largest budget deficit of the post-war period. In 1948 the acquisition of foreign exchange ranked almost equal with Government borrowing from the central bank as a factor in the expansion of the credit base. In 1949, when the effect of Government transactions with the central bank was deflationary, owing to the accumulation of the counterpart funds of foreign aid, it remained as the only expansionary factor.

A decline of prices to a level which had been attained as late as the spring of 1946 was in the nature of a descent from a narrow peak on which no consolidated structure of debt had been erected. Nor did it eat into the profits which borrowers had realized, thanks to the depreciation of the currency, on the large mass of debt obligations contracted before May 1947. This favourable situation in respect of the outstanding, or recurrent money claims of lenders, Government and wage earners was a key factor helping business firms to maintain financial balance in a declining market.

The general index of wholesale prices (1938 = 1) which had climbed from 26 in June 1946 to 51 in May 1947 and 62 in September, fell back to 51 in June 1948.

A short revival of the upward tendency took place between June and October 1948, as a result of the higher official price for wheat that was adopted in the new crop year in order to reduce the burden of food subsidies. But slightly deflationary tendencies continued to prevail in Italy, in line with international developments, during 1949; and the price index eased to a low of 47 in June 1950.

The index of industrial production, seasonally adjusted, fell a few percentage points in the closing quarter of 1947 and production stagnated in the winter months of early 1948. It then recovered for a while, but suffered late in the year from a shortage of hydro-electric power and from the recession abroad. Expansion was resumed at a more secure pace in the spring of 1949; it started from levels roughly in line with the 1947 summer peaks and carried the index some 15 per cent above them, and 26 per cent over the 1938 average, by June 1950.

26. Between the closing months of 1947 and the winter months of early 1949, while production stagnated, the country's foreign exchange position improved substantially. A major debate developed at the time in Italy and the United States (administering ERP aid) about the policy implications of such divergent trends — the division of opinion cutting across the nationality line. One view found expression in the "country study" for Italy issued by the U.S. Economic Cooperation Administration (ECA) in February 1949 (25), which recommended a more "aggressive" credit and investment policy.

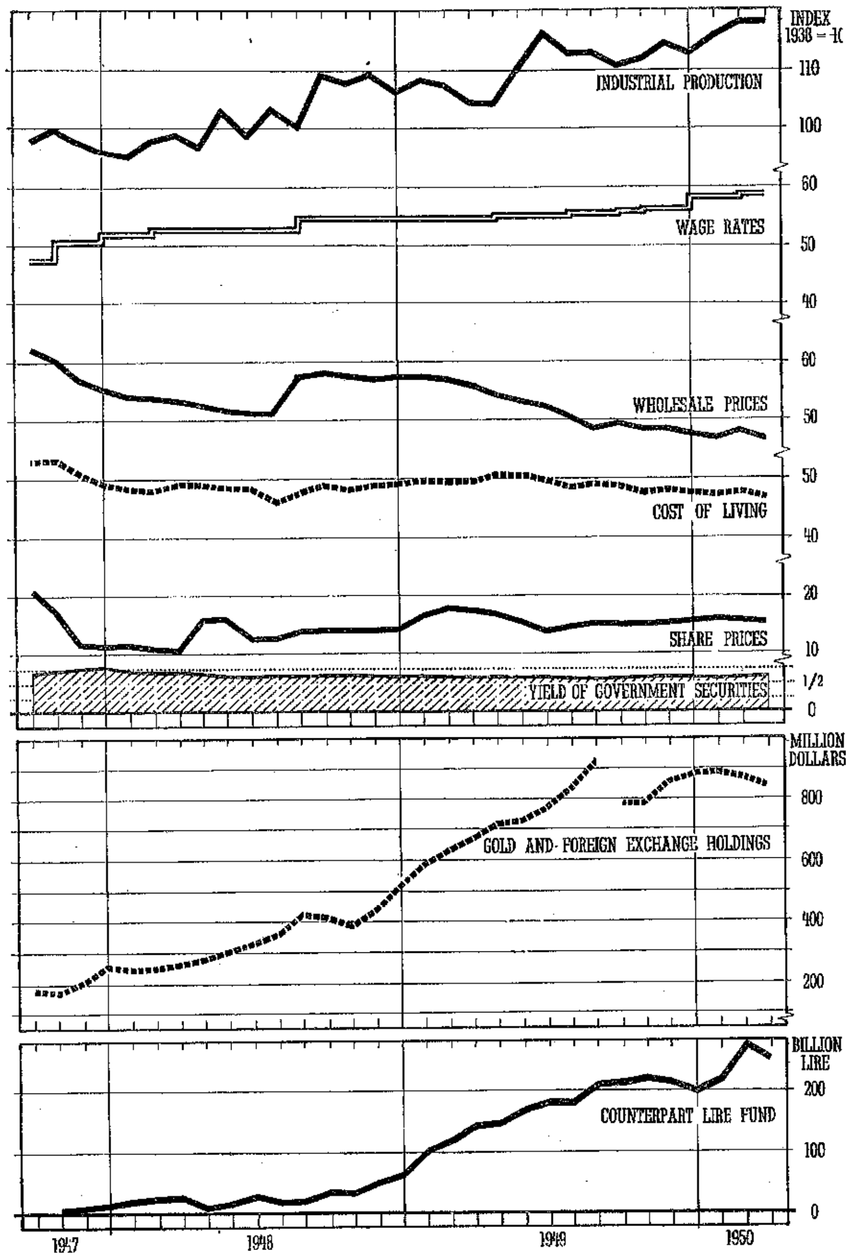
In the Italian Government, the influence of moderate opinion had been reinforced by the triumph of the Catholic party in the April 1948 elections. The Government kept to the Einaudi line of strengthening the lira, and, to foreign observers impressed by the high level of unemployment, may have seemed inhibited by an acute inflation consciousness. Though this factor did play a role, the facts of the situation gave the Italian authorities more rational motives for attaching a high priority to the replenishment of the foreign exchange reserves (26).

Since the building-up of the stock of gold and foreign exchange had to begin almost from nothing, the size attained by that stock at the beginning of 1949 was still small when compared with possible swings in the balance of payments, under conditions of expan-

(25) Cf. also J. J. KAPLAN, *Economic Stagnation in Italy?* (Yale Institute of International Studies, 1949); F. W. RIGGS, *Italy's Road Back* (Foreign Policy Reports of the Foreign Policy Association, 15 May 1949).

(26) A nicely balanced presentation of the cases for and against an expansive policy in 1949 is offered by LUTZ, *op. cit.*

CHART 9 - THE POST-STABILIZATION DEFLATIONARY ADJUSTMENT



sion, and imminent liberalization, of foreign trade. The holdings consisted in large part of pounds sterling and other inconvertible currencies. Their growth largely reflected the influence of non-recurrent factors, such as the disposal of stocks, the return of flight capital, and the granting of credit by foreign suppliers. To a lesser extent it reflected a surplus of current receipts over outgoings, connected with the conditions of bilateral payments agreements and with the artificial exchange rates prevailing at the time.

The increase in foreign exchange holdings continued during the remainder of 1949, when, however, the simultaneous expansion in production made the policy alternatives less sharp.

During the two years 1948 and 1949, the net accumulation of foreign exchange reserves amounted to some 600 million dollars. This figure was made possible to the extent of about 280 millions by the financing of imports through capital repatriation or balances held abroad but not included under official foreign exchange holdings in 1947, and to the extent of another 220 millions by long-term borrowing abroad (including ERP loans) and by other foreign investment in Italy. The favourable balance on current account (including grants among the credit items) provided the remaining 100 millions, or that is one sixth of the total.

The extent to which the current surplus was affected by the artificialities of payments arrangements and exchange rates, rather than by the basic relationships of competitive power, is shown by the development of the trade balances with Argentina and with the sterling area. In September 1947, a payments agreement was concluded with Argentina which, in addition to a large short-term credit line on both sides, envisaged a long-term loan to Italy. It was not long before Italy was making substantial use of both forms of credit to finance imports of basic foodstuffs, and her indebtedness to Argentina increased by nearly 150 million dollars within nine months. It was partly due to these imports that the post-stabilization price drop was particularly sharp for basic agricultural commodities. From September 1948 on, however, the position was reversed: Italy reimbursed her short-term debt and, by September 1949, was accumulating funds in Argentina for the servicing of the long-term debt.

The conclusion in November 1948 of an Anglo-Italian payments agreement put an end to the fluctuating market for sterling, which had been quoted for the past year at lira rates corresponding

to cross-rates of 3-3.30 pounds to the dollar. The acceptance by the Italian negotiators of the high official rate of 4.03 opened up the prospect of a substantial expansion of exports towards the sterling area; these expectations were in fact fulfilled by the accumulation of a surplus amounting to 60 million pounds in the space of nine months. The 30 per cent devaluation of the pound in September 1949 (compared with one of only 8 per cent for the lira — from 575 to 625 lire to the dollar) put an end to this process.

27. The protagonists of a more active investment policy maintained that the accumulation of foreign exchange reserves was harmful to Italy inasmuch as it led to a reduction in the share of ERP aid allocated to her. Their argument assumed that the allotments to individual countries would be positively correlated with the size of their foreign deficits. This factor unquestionably played a role in the first phase of the aid programme: and, in so far as it referred to deficits incurred in the recent past, it must have favoured Italy, where, in the inflationary conditions of 1947, the import surplus of goods and services had reached an all-time record of 800 million dollars. A fairly stable pattern of aid distribution was maintained by ECA in later years, when the replenishment of foreign exchange holdings came to be recognized as a legitimate use for aid received. Italy's share of ERP grants and loans remained unchanged at 11% from the first period (April 1948-June 1949) to the second period (1949/1950) or that which followed the publication of the ECA Country Study. It was raised to 12.7 per cent in 1950/1951 (27). There may have been some scope for an upward revision of the amount allotted to Italy, but the contribution such a revision could have made towards relieving the balance of payments impact of a policy predicated upon an expansion of imports was a limited one. A needed sense of proportion is induced by the consideration that the total of the credit items on current account in the years 1948 and 1949 was 3,500 million dollars.

Italy's policy of making the lira secure before embarking on a programme of expansion helped her to avoid balance of payments crises in later years. In contrast to the three major countries of Western Europe, to Scandinavia and to the overseas sterling area, where the process of liberalization of foreign trade and payments

(27) The absolute figures were of 668 million dollars in the first fifteen months, 403 millions in 1949/50 and 237 millions in 1950/51.

had at times to be interrupted or reversed in order to husband limited foreign exchange resources, Italy was able to advance towards free foreign economic relations without a break. Liberalization took place in two stages. In the first stage (1950) the percentage of quota-free imports from OEEC countries was raised to 54% in January and 76% in September. In the second stage (November 1951) the percentage of liberalization was raised to 99% mainly by the removal of quotas applying to manufactured goods, while duties were reduced by an all-round 10%. The liberalization of dollar imports proceeded at a slower pace than the foreign exchange position would have necessitated; it has been speeded up in recent years.

28. In the early post-war years, the volume and direction of Government investment were dictated by reconstruction needs, especially in the sectors of transportation and public utilities, which had severely suffered from war destruction.

The transition to a policy of consciously promoting investment took place gradually after the restoration of price stability; it gained momentum in the year preceding the Korean crisis.

Emergency measures to relieve the plight of the mechanical engineering industries were quickly adopted in September 1947, when the liquidity squeeze deprived these industries of access to additional bank credit.

In late 1947, the Government exempted from the payment of duty imports of machinery and of materials needed for the establishment of new industrial enterprises in the South, and appropriated funds for granting credit to industry in the same regions.

A Government programme for subsidizing building activity was launched by Minister Fanfani in the second half of 1949. Investment incentives might have been given with less risk in this sector than in others even in 1948. They would have been a way of offsetting the disincentive effect of rent control. The import content of building materials is low and factor proportions in building are variable within wide limits. Moreover, substantial unemployment existed in the building sector, and prices of materials, like those of foodstuffs, were declining. The desire to take advantage of Government subsidies provided a powerful stimulus to saving among prospective home owners, and the consumption goods thus released could have covered at least part of the needs of the newly employed

workers. The delay in Government action in the face of such favourable circumstances must be ascribed to a "lagged reaction" to the change from an inflationary situation to a slightly deflationary one.

The financing of investment from ERP counterpart funds was also slow to get going. This delay was partly due to the time-consuming procedures governing the release of funds by the ECA authorities. The first substantial releases were made towards the end of 1949.

In April 1950, 50 million pounds from the official holdings were allocated to the purpose of financing, at preferential interest rates, imports of machinery and other capital goods.

In the case of the counterpart lire, the accumulation of the funds necessarily preceded their disbursement. This time sequence led to a strengthening of the deflationary pressures preceding the Korean crisis and of the inflationary stimuli following it. The lending out of foreign exchange was an additional factor working in this second direction.

29. The investment policies of the Government in those years did not form part of any established programme. The idea of development planning was not familiar to Italian thinking, and the impulse towards its acceptance came from the activities and the procedures of international agencies such as OEEC, ECA, and the International Bank for Reconstruction and Development.

The mapping of development programmes was first started as part of the required basis for the allocation of American aid. On that occasion (1948), the then Minister of Industry, Tremelloni, presented to OEEC a long-term programme covering the four years of ERP. The programme envisaged the attainment of international viability, i.e. balance of payments equilibrium, by 1952/1953; but it also made clear that viability was not to be interpreted as including full employment.

The ECA country study of February 1949 warned that "given the shyness of private investment in Italy" the results envisaged in the Italian programme could be obtained only through "the formulation of a national investment plan (included in a national economic budget) and its implementation by Government departments, semi-governmental agencies and the banking system ".

Meanwhile, the IBRD was sending to Italy its first fact-finding missions, which concentrated their attention on the development problem of the South. Italy was represented at the time, in the IBRD, by some of her most eminent citizens, i.e. by the Governor of the Bank of Italy, Menichella, in the Board of Governors, and by Professors Bresciani Turroni and Giordani in the Board of Directors.

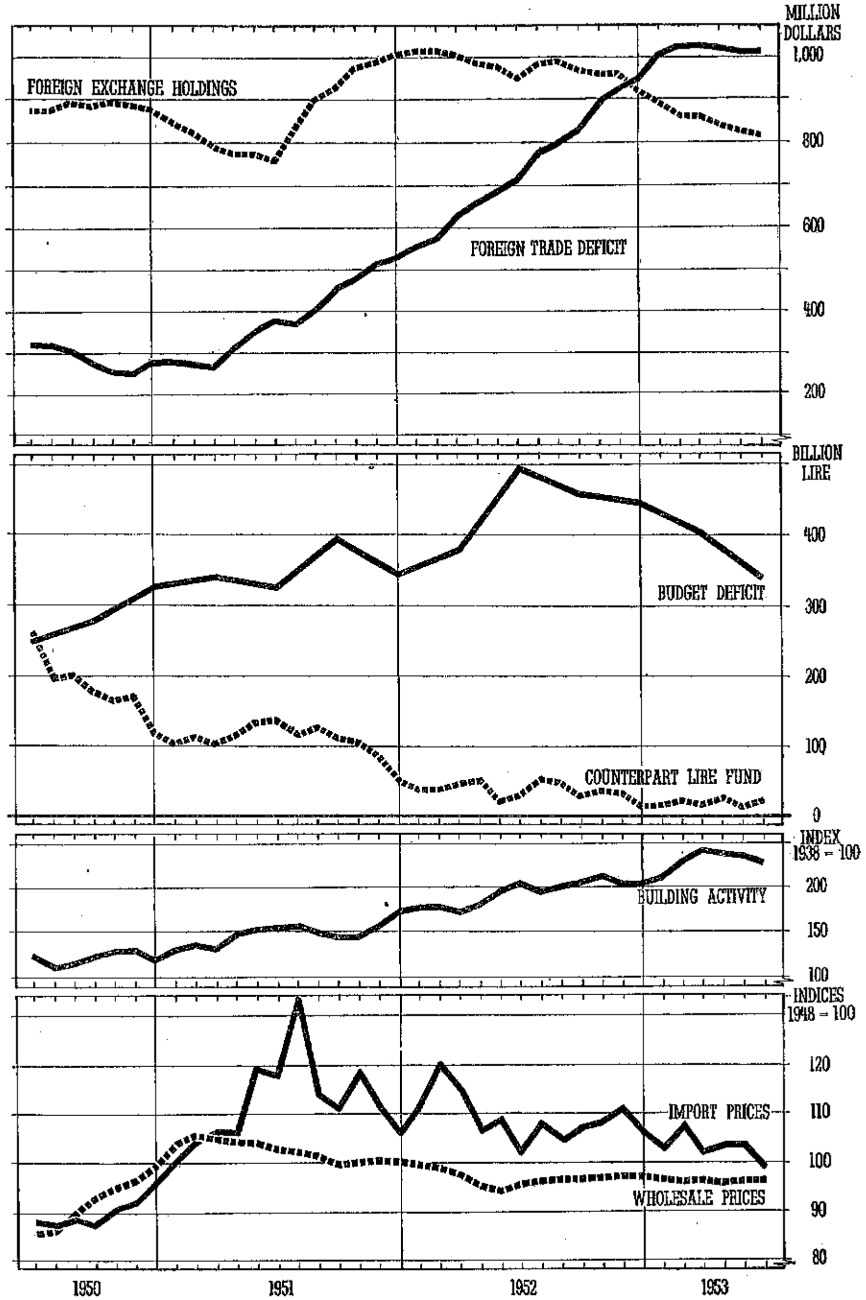
In 1950, the seeds which had been sown in the previous years germinated with the establishment of a special agency for the development of the South (the *Cassa per il Mezzogiorno*). This agency was endowed, through budget appropriations, with 1,000 billion lire (1,6 billion dollars) to be spent over ten years (later raised to 2,040 billion lire to be disbursed over 15 years). In addition, all the loans so far granted by the IBRD to Italy (240 millions dollars) have been conveyed through the same agency to development projects in the South in the fields of power, irrigation and manufacturing industry.

30. When the Korean war broke out, neither the banks nor the business and the personal sectors were in possession of any significant amount of excess liquidity, notwithstanding the prevalence of deflationary impulses (28) during the previous two years. This seeming paradox is explained by the following factors: (a) The stock of money had lagged behind the national product in 1946/1947. As previously seen, it caught up with an expanding national product only in the second half of 1949 (chart 8). (b) The increase in Bank of Italy assets from September 1947 to June 1950 was matched, on the liabilities side, by increases in the note issue (which is tied up in wage payments and ordinary consumers' transactions), in foreign aid counterpart funds and in compulsory reserve balances. Free bank deposits actually declined (29).

(28) For the concepts of inflationary and deflationary impulses used here, cf. M. W. Holtrop, " Ueber die Deutung monetärer Erscheinungen ", *Weltwirtschaftliches Archiv*, Band 79, Heft 2, 1957.

(29) Bank of Italy assets expanded from 774 billion lire in September 1947 to 1,605 in June 1950. (Government deposits, other than the counterpart funds, have been subtracted

Chart 10 - THE KOREAN WAVE



In these conditions an autonomous process of inflationary financing on the part of business could not proceed very far without forcing the banks into the central bank. The foreign exchange made available from official holdings to finance imports of equipment goods and the drawings on the counterpart fund balances (they were reduced from 261 billion lire in June 1950 to 134 in June 1951) were relieving factors. But a state of credit stringency developed in the spring of 1951 and some ineffective protests were raised against it.

The effects of the "Korean wave" are shown in Chart 10 and an analysis in terms of credit flows is given in Table 6. The wholesale price index (1938 = 1) advanced by 20 per cent in one year (from 47 in June 1950 to 56 in June 1951) while average import prices rose by 34 per cent and prices of imported raw materials by 45 per cent. Foreign exchange holdings stopped expanding in 1950 and contracted in the first half of 1951. The high import demand kept the rate of growth in the money supply, during the twelve months, down to 12 per cent, the figure to which it had fallen in the previous twelve months (1949/1950). (The rate had been 18 per cent in 1948/1949 and 37 per cent in 1947/1948). The tightening of the monetary position was reflected in an increase in the loan-deposit ratio from 0.69 in June 1950 to 0.76 in June 1951; a decrease of the cash-deposit ratio from 11.6 per cent to 8.8 per cent; and a slight temporary reversal in the downward trend of the income velocity of money (Chart 1).

The stringency came to an end after the passing of the June 30 seasonal low. International raw material prices had been falling since March, and primary producers were now spending, with the usual time-lag, the foreign exchange acquired in the previous boom. Given the full employment of capacity existing in most Western European countries, Italy took up her role of marginal supplier,

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from Government borrowing). The changes in individual groups of items account for the following percentages of the total increase:

Assets		*Liabilities*	
Acquisition of foreign exchange	54	Currency	38
Lending to Government	35	Counterpart funds	31
Lending to banks	11 (*)	Statutory reserve deposits	28
		Other bank deposits	−4
		Other items	7

(*) Includes small amounts lent to non-bank customers.

mainly of textile and engineering products and especially to the markets protected by imperial preference in the British Commonwealth. The boom in exports continued until the early part of 1952. Italy's position in EPU swang round from a large cumulative debtor position (— 84 million dollars) in March 1951 to an extreme creditor position (209 million dollars) in February 1952.

31. During the year following the outbreak of hostilities in Korea the banks were faced with a heavy demand for credit, while losing reserves through the foreign payments deficit. The rate of loan expansion which they attained (24 per cent) was lower than the rate reached in the recent past, in periods both of inflation and of deflation. It compared with *per annum* rates of 110 per cent from July 1946 to September 1947 and 33 per cent from October 1947 to June 1950. The central bank expanded its lending to the commercial banks during the year by an amount almost equal to the increment in their reserve obligations. The whole expansion in bank assets consisted of loans to the business sector, the change in cash being nil and that in holdings of Government securities slightly negative. The expansion in the note issue was roughly matched by releases from the counterpart funds.

The inflow of foreign exchange was the main source of money creation during the second half of 1951 and the early months of 1952, after which the foreign payments position again turned against Italy. The contraction in liquidity associated with the loss of foreign exchange during the remainder of the year was more than offset by the effect of the increase in the budget deficit.

The figures on the right-hand side of Table 6 show that during the backwash of the Korean wave (July 1951 to December 1952) four main sources of inflationary financing were used by the Government: (a) borrowing from the central bank; (b) the investment in Government securities of the banks' statutory reserves; (c) the drawing down of the balance of the ERP counterpart funds; (d) the voluntary acquisition by the banks of Government securities.

The last item was also fourth in order of importance; the expansion in bank loans over the same period was ten times larger. From mid-1951 to mid-1952, while industrial production marked time and prices declined, the rate of expansion of bank loans was maintained at 19 per cent; it climbed to 27 per cent from July 1952 to June 1953.

Table 6

CHANGES IN HOLDINGS OF LIQUID ASSETS AND THEIR SOURCE (1)

(Billions of lire)

Transactions	Total (12 months)	July 1950 to June 1951: Banking system: Bank of Italy	July 1950 to June 1951: Banking system: Other banks	July 1950 to June 1951: Economic sectors: Govern-ment	July 1950 to June 1951: Economic sectors: Business and per-sons (a)	July 1950 to June 1951: Economic sectors: Foreign countries	July 1951 to December 1952: Banking system: Bank of Italy	July 1951 to December 1952: Banking system: Other banks	July 1951 to December 1952: Economic sectors: Govern-ment	July 1951 to December 1952: Economic sectors: Business and per-sons (a)	July 1951 to December 1952: Economic sectors: Foreign countries	Total (18 months)
(1)		(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	
Acquisition of foreign exchange by B. of I. and Exchange Office		− 71.4				− *71.4*	76.9				*76.9*	
Extension of B. of I. credit to other banks		59.1	*59.1*				− 62.4	− *62.4*				
Discounts of wheat bills by B. of I. (b)		22.6	*6.0*	*16.6*			66.0	*37.9*	*28.1*			
Statutory reserves held at B. of I. and related investments		11.4 (c)	5.6	*17.0*			58.3 (c)	107.3	*49.0*			
Other B. of I. loans and investments		− 68.3		− *74.8*	*6.5*		182.9		*186.9*	− *4.0*		
Deposits held at B. of I. by other banks and Government		− *104.5*	− 1.2	− 103.3			− *81.2*	22.7	− 103.9			
Direct investment of statutory reserves by other banks			49.4	*49.4*				83.8	*83.8*			
Loans and investments by other banks			348.8	− *7.1*	*355.9*			867.8	*99.3*	*768.5*		
Banking system as a whole		57.9	337.5	*104.4*	*362.4*	− *71.4*	286.3	1,106.1	*551.0*	*764.5*	*76.9*	
Treasury short-term borrowing from the public				*34.4*					*54.9*			
Changes in holdings of financial assets by the business and personal sector												
money supply												
currency (d)	118.3	*105.1*	*11.7* (e)	*1.5*			*292.3*	*8.6* (e)	*17.6*			318.5
current accounts	135.7	− *31.5*	*154.7*	*12.5* (f)			− *0.3*	*612.2*	*12.5* (f)			624.4
secondary liquidities	175.8	− *15.7*	*171.1*	*20.4*			− *5.7*	*485.3*	*24.8*			504.4
all liquid holdings	429.8											1,447.3
other financial assets (g)	312.1											557.3
all recorded assets	741.9											2,004.6

(a) Figures in italics show changes in liabilities of the transactor to which the *column* relates. Local authorities are included with business and persons.
(b) Bills from previous crop years discounted at the Bank of Italy are treated as a claim against the Government.
(c) Excess of investment by Bank of Italy over statutory reserves held with it, or *viceversa*.
(d) Inclusive of circular checks.
(e) Issue of circular checks, net of increase in bank cash. The relevant figures in the two periods are 12.1 and 37.7 billion lire for the issue of circular checks; 0.4 and 28.1 billion lire for the increase in bank cash.
(f) Inclusive of deposits on current account at Post Offices.
(g) As from following breakdown:

	Jul. 1950 to Jun. 1951	Jul. 1951 to Dec. 1952
Post Office Savings	122.3	234.0
Long-term Government securities	71.8	84.9
Bonds	65.0	113.0
Shares	53.0	125.4
Total	312.1	557.3

32. The two cyclical movements shown in Tables 5 and 6 provide the student of monetary phenomena with valuable illustrations of the relationships between the foreign balance, domestic liquidity and the volume of credit. The relevant magnitudes are depicted in Chart 11. The chart takes in the years following 1952, so as to include a third major "wave" which covered Italy along with the rest of Western Europe, i.e. the post-Suez deterioration in the balance of payments and the swing back to an impressive surplus which started in the third quarter of 1957.

For each date (end of quarter) indicated, the chart shows the magnitude attained, during the twelve month period closing on that date, by the following phenomena:

(A) the acquisition (or loss) of foreign exchange, which is shown on the negative part of the scale, since it may be taken to represent the liquidity deficit (or surplus) of foreign countries over the period, though of course it includes newly produced gold;

(B) the Government liquidity deficit, consisting of short-term borrowing and the use of liquid balances;

(C) the liquidity surplus of the rest of the economy, which for the sake of brevity is called the "private sector". This surplus is equal to the sum of the deficits (A) and (B), with sign reversed;

(D) the change in the gross liquidity holdings of the private sector, which is equal to (C) plus the borrowing of the private sector from the banking system.

The change in the indebtedness of the private sector towards the banking system is thus represented by the difference between the ordinate (D) and the ordinate (C).

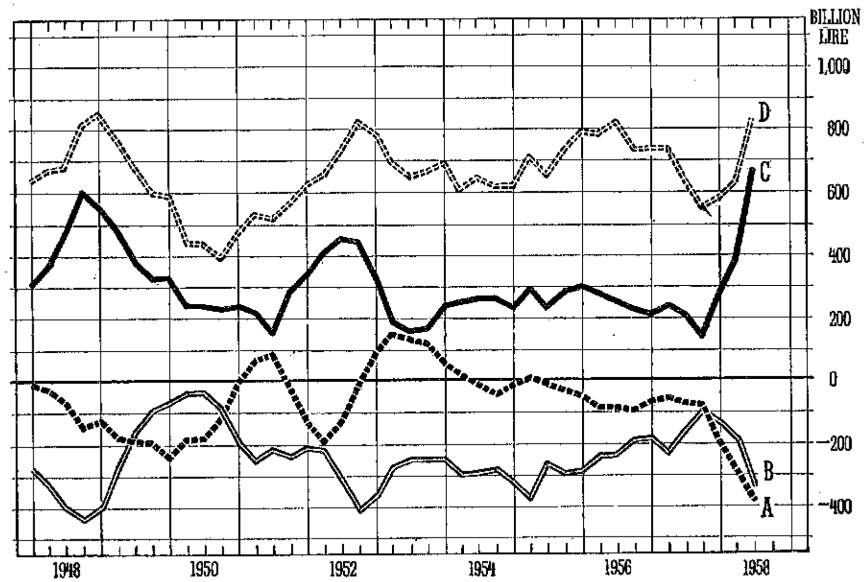
The chart makes it clear that the liquidity deficit of the Government was the principal channel by which private liquidity holdings were reconstituted in the year 1948. The creation of additional liquidity in the private sector slowed down during 1949, in consequence of the reduction in the liquidity deficit of the Treasury between the beginning of 1949 and June 1950, a reduction which was only partly offset by the growing external surplus.

In the year of the Korean boom the roles of the two factors providing liquidity to the private sector were reversed. The liquidity provided by the expansion in the Treasury deficit was absorbed by the foreign payments deficit. Additions to gross liquidity were declining in magnitude up to September 1950 and those to net

liquidity were declining up to June 1951. This lag signifies that bank lending to the private sector between the two dates was relatively more important as a liquidity creating factor than it had been previously.

Between June 1951 and March 1952, there took place the large expansion in liquidity associated with the balance of payments surplus; additional liquidity continued to be created at a rapid rate

CHART 11 - SECTOR LIQUIDITY POSITION, 1948 to JUNE 1958



(A) Liquidity deficit of foreign countries. +
(B) Liquidity deficit of the Government. + borrowing of the priv. sect. from banking
(C) Liquidity surplus of the private sector. = D
(D) Gross liquidity holdings of the private sector.

until towards the end of 1952 as a result of the budget deficit. The expansion of bank lending continued at a high level. At the beginning of 1953, the current liquidity surplus of the private sector fell abruptly, as the Treasury deficit diminished and the foreign exchange deficit increased. The downward movement in the growth of gross liquidity holdings was less pronounced since the expansion of bank lending was even more rapid than before.

From 1953 to mid-1956 (Suez) the movements were smoother. The Treasury deficit continued to contract, and the foreign exchange position improved; net liquidity formation was accordingly kept at an even level, while bank lending and the related gross liquidity formation went on expanding in line with the general development of the economy.

The period July 1956 to September 1957 represented the first phase of the last wave: the Treasury position continued to improve while there was a slight deterioration in the foreign balance. After September 1957 the deterioration in the Treasury position (30) combined with the balance of payments surplus to bring about an exceptionally large increase in liquidity, and the expansion of bank lending slowed down markedly, so that the curve depicting net liquidity creation in the private sector draws near to that showing the change in gross liquidity.

The inclusion of the three cyclical movements of the decade in the single picture just drawn makes it possible to distinguish more clearly the typical and atypical features of the movements which took place in 1952.

(a) The improvement in the foreign balance between July 1951 and March 1952 belongs to those features which are characteristic of periods of recession: it was present both throughout the two-year period 1948-1949, and after September 1957. The deterioration in the balance of payments position between March 1952 and the beginning of 1953 appears, however, to be atypical.

(b) The increase in the Treasury deficit during the year appears as a typical aspect of periods of recession: it was present both in 1948 and after September 1957. What seems to be outside the normal pattern is the Treasury position in 1949, to which reference has been made above (No. 28).

(c) A phenomenon which merits attention and which is brought into relief by the 1952 experience is the uninterrupted expansion of bank credit in a period of recession.

An analysis of these points is given in the next three sections.

33. The November 1951 measures of import liberalization were adopted in view of the favourable turn in the balance of

(30) Due not to a worsening of the budget position but to the suspension, in 1958, of the annual issue of Treasury Bonds which had been a feature of the years from 1951 to 1957.

payments. While the process of freeing foreign trade was marked by continuity and was unaffected by foreign exchange crises (No. 27), in its timing the foreign payments position did take precedence over considerations of business cycle policy. Had the liberalization policy been given a specific countercyclical function, it should have been introduced in the previous boom, when, however, reserves were dwindling. As it happened, the gates were opened wider to foreign competition at a time of declining domestic demand.

The line taken by the Government at this juncture may be ascribed to the importance attached to the foreign exchange position in the formulation of policy as well as to a characteristic focussing of such policy on long-range objectives, and its lack of flexibility in the short run. Industry took up the challenge embarking on programmes of modernisation that heightened its competitive power.

The rise in the trade deficit from 276 million dollars in 1950 to 520 million in 1951 and 949 million in 1952 may be imputed to several causes:

(1) The resumption of trade restrictions by France, Britain and the overseas sterling area, in the early months of 1952, aggravated the fall in Italian exports which would in any case have accompanied the end of the boom. Textile exports slumped from 716 million dollars in 1951 to 331 million in 1952.

(2) A factor of a more general character increasing the deficit was the settling down of international prices at a level which was higher than the pre-Korean one. The index of import prices (1953 = 100) had risen from 87 in 1950 to an average of 110 in 1952. Applied to the 1950-deficit (of 276 million dollars) this increase meant an addition to the deficit in 1952 of 73 million dollars. A further addition, equivalent to an estimated 135 million dollars, was due to the deterioration in the terms of trade between 1950 and 1952.

(3) Imports of the goods that were liberalized in November 1951 expanded in 1952 by 96 million dollars over the 1951 level.

(4) Official policy tended to expand imports in more direct ways than through the liberalization measures:

(a) During the years 1948 to 1950, the Italian Government, in conjunction with ECA, provided foreign exchange equivalent to 250 million dollars (either directly from ERP loans, or indirectly by releasing lire from the counterpart funds) to finance imports of equipment from the United States. Because of the time that was technically necessary for the granting of the finance, and the placing of orders, and owing to the difficulty of obtaining deliveries during the Korean boom, the peak volume for these imports was reached in 1952.

(b) The fund of 50 million pounds sterling made available in April 1950 for the purchase in the sterling area of machinery and equipment, and ships was drawn on in 1952 for financing imports equivalent to 25 million dollars.

(c) As a means of assuring the national economy of the uninterrupted availability of supplies in any future political crisis that might occur, the Government, after the Korean experience, initiated in July 1951 a stock-piling programme. For this purpose there were imported in 1952 foodstuffs (grain, oil-seeds) and raw materials (copper, tin, rubber, coal) for a value equivalent to 40 million dollars.

(d) Finally, at the same time as the liberalization measures were taken in November 1951, 60 million dollars' worth of EPU currencies were provided from official reserves for the granting of loans at especially low interest rates to finance imports from EPU countries and their associated territories. The imports made under this provision were concentrated in the year 1952.

34. The figures for the budget deficits of the Government, whether calculated on a cash or accruals basis, show, during this ten-year period of stability, two peaks, relating to the fiscal years 1947/1948 and 1952/1953 (Chart 5).

The coincidence of these two peaks with years of a low rate of increase in output must be ascribed to the interplay of institutional factors and market adjustments which has effects that are *as a rule* in harmony with those of a deliberate anti-cyclical policy. A number of points are relevant in this connection.

The level of the Government's disbursements is influenced by its cash position, or that is by the level of tax receipts and of the proceeds of security issues. This second component is more variable than the first. The experience of post-war years has been that at times of active private demand, when concern about monetary stability was growing and the inflow of loan funds to the Treasury declining, both the legislative and the executive branch of Government became reluctant to commit the State to new expenditure, and the Treasury itself tended to delay disbursements. At times of falling private demand, the easing of the Treasury position and the reversal in the nature of the Government's worries made for greater willingness to pay off arrears and obligations currently falling due, and for a readier acceptance of new spending commitments. As a result, aggregate disbursements have shown a tendency to reflect almost automatically the changes in the flow of funds seeking investment through the Government. Certain departures from this course will be mentioned later on.

Little use was made of a flexible interest rate policy as a means of governing the size of this flow. The rate of interest on Treasury Notes (which were always on offer in unlimited quantities) was lowered by one point during the ten years 1948-1957. It was brought down from 5 to 4 per cent by two reductions of half a point each. In the conditions of high liquidity which prevailed in 1958 the rate was further reduced to 3½ per cent. Nine-Year Treasury Bonds were issued during the years 1950 to 1955 at the nominal rate of 5 per cent and at effective yields close to 5.9 per cent. The yields rose slightly in the years 1956-1957 when the market showed a certain reluctance to absorb additional Government securities. The rate offered on the second type of medium-term indebtedness, the Postal Savings Certificates, was changed (downwards) only twice during the eleven years 1948-1958.

Changes in the level of local Government spending are also, though somewhat loosely, connected with cyclical changes in the supply of savings.

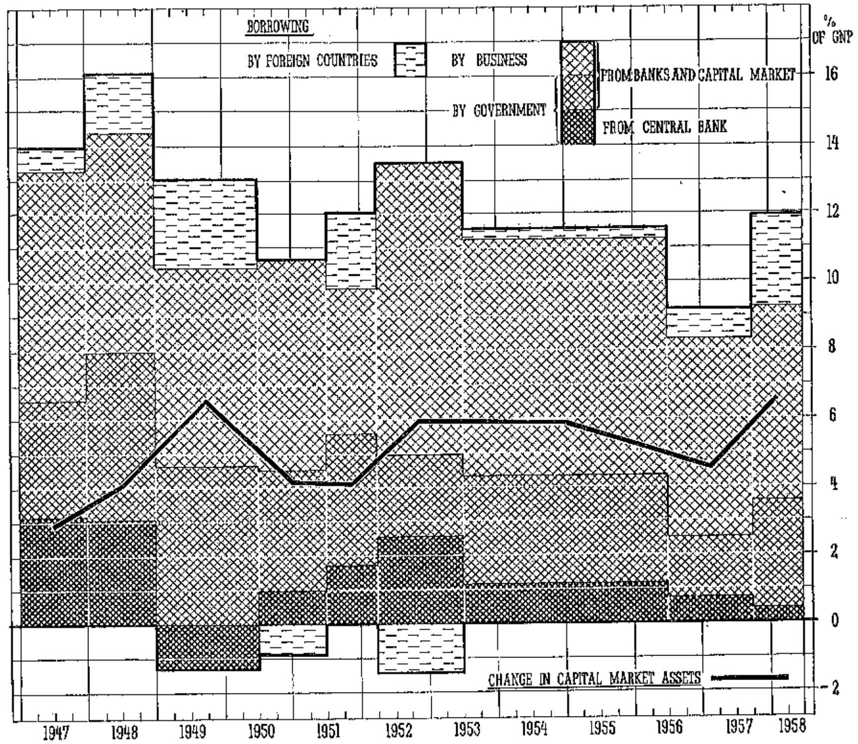
The local authorities finance their investments with funds obtained from the ordinary Savings Banks, from the Credit Consortium for public works (*Consorzio di credito per le opere pubbliche*) (31), and from the *Cassa depositi e prestiti* which administers postal savings. The limit to the volume of their investments is set by the amount of finance obtainable from these bodies. In particular, the part of postal savings available to the local authorities is the part which is not pre-empted by the Treasury.

During the last ten years the factors just described worked in such a way as to give to spending, and to the deficit in the public

(31) The local authorities discount with this body the annual contributions due from the Central Government or pledge their own tax revenues.

sector (32), cyclical movements in the same direction as, but of smaller magnitude than, the analogous movements in receipts from taxation and from loans (where the latter are taken exclusive of

CHART 12 - FORMATION OF FINANCIAL ASSETS AND RELATED BORROWING TRANSACTIONS, 1947 to JUNE 1958



borrowing from the central bank). Consequently the balance which was drawn from, or paid back to, the central bank likewise showed a cyclical movement.

(32) The figures for the public sector shown in the table relate to the Central Government, to public services run by Government bodies (railways, highways, long distance telephone lines) and to the local Government authorities. They do not embrace the many industrial activities (in the regional telephone services, power, shipping, iron and steel, engineering, and chemical sectors, etc.) carried on by companies controlled by the two powerful Government holding-companies (IRI and ENI). These companies have so far followed investment criteria akin to those of private business.

The figures for private sector borrowing at the banks includes small amounts borrowed at the central bank.

TABLE 7

SECTOR BORROWING AND RELATED CHANGES IN FINANCIAL ASSETS

(Yearly rates in billions of lire)

	(A) Borrowing (*)								Total (A)=(B)	(B) Change in financial assets			GNP	Ratio of (9) to (13) (per cent)
	By domestic sectors							By foreign countries (acquisition of foreign exchange)		Liquid holdings		Other		
	Public sector			Private sector										
	Statutory bank reserves (**)	Other borrowing: From the central bank	Other borrowing: From other banks and the capital market	From banks	From the capital market	Total (1) to (5)	Percentage ratio of (3) to (6)			Primary (Money supply)	Secondary			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
Jan.-Dec. 1947	93	96	204	353	50	796	*25.6*	13	809	479	158	172	5,992	*13.5*
Jan.-Dec. 1948	151	63	347	342	111	1,014	*34.2*	125	1,139	509	345	285	7,068	*16.1*
Jan. 1949-Jun. 1950	78	- 173	342	225	207	679	*50.3*	194	873	169	221	483	7,412	*11.7*
Jul. 1950-Jun. 1951	55	34	324	408	156	977	*33.2*	- 79	898	286	230	382	9,141	*9.8*
Jul. 1951-Mar. 1952	126	48	391	291	143	999	*39.1*	226	1,225	505	301	419	10,185	*12.0*
Apr. 1952-Jun. 1953	113	146	247	570	303	1,379	*17.9*	- 145	1,234	355	273	606	10,189	*12.1*
Jul. 1953-Jun. 1956	110	30	395	546	317	1,398	*28.4*	37	1,435	377	328	730	12,441	*11.5*
Jul. 1956-Sep. 1957	96	15	264	490	377	1,242	*21.2*	127	1,369	328	360	681	14,941	*9.2*
Oct. 1957-Jun. 1958 (***)	195	- 135	467	305	532	1,364	*34.2*	396	1,760	499	292	969	14,779	*11.9*

(*) Figures for borrowing by the public sector are net of changes in holdings of deposits by the sector.

(**) Figures in column 1 show the total change in statutory reserves over the period. In calculating the figures shown in column 2, any amount of statutory reserves not invested in Government securities has been counted as a claim of the Government on the central bank.

(***) Partially estimated data.

The interrelations with which we are concerned here are illustrated in Table 7 and Chart 12.

The formation of financial assets, expressed as a ratio to the national product, reached its cyclical peaks in three out of the four periods of weak domestic demand shown in the table, i.e. in 1948, in the two sub-periods of the post-Korean recession (July 1951 to March 1952, and April 1952 to early 1953), and from September 1951 up to the end of 1958. The growth of financial assets was slower in the fourth period of less active demand, i.e. the one from January 1949 to June 1950, when a powerful liquidity-restricting factor was at work, in the shape of the accumulation of the counterpart funds (33).

The extent to which the public sector contributed to the total increase in domestic indebtedness towards the banks and the capital market (34) was largest in the three periods of high availability of funds. The other two periods of weak demand presented dissimilar experiences. In 1949 and the first half of 1950 the large Treasury drawings from the market were in good part shifted on to the central bank. Between April 1952 and June 1953, on the other hand, the Treasury borrowed little from the market and drew directly on the central bank. Both periods were marked by a certain lack of responsiveness of Government expenditure to the supply of finance. During the first period, there was no effectively implemented business cycle policy; during the second, development policy measures superimposed their reflationary effects upon those of business cycle policy. The actual disbursements of the Fund for the development of the South (*Cassa per il Mezzogiorno*) did not reach massive proportions until 1952. In July of that year, again on the initiative of Minister Fanfani, a comprehensive law was enacted, designed "to foster development and increase employment". The law provided Government finance and subsidies for a variety of purposes of interest to wide social groups. Under it the investment programmes for the South and for depressed areas

(33) The proposition that balance of payments deficits and surpluses affect liquidity is not meant to express a causal relationship. The primary impulse, in the line of causation leading to the balance of payments position, is given by the inflationary or deflationary behaviour of the transactors (Government, business and persons) inside each country. Cf. HOLTROP, *op. cit.*

(34) It has already been pointed out (footnote No. 23) that the term "banks" excludes the central bank. The issuing of shares is considered as analogous to the raising of loans on the capital market.

in the North were broadened; a revolving fund was set up for financing farm mechanisation, irrigation and rural construction projects; a central institute was established (with Government-provided capital) for rediscounting loans granted by authorized banks to medium- and small-size industrial firms. Finance was also provided for land reclamation works, handicrafts, the construction of natural gas pipelines, shipbuilding, and make-work projects to relieve unemployment (both 1952 and 1953 were election years). To finance the last a special payroll tax was levied on industrial enterprises; the rate was 2% on wage payments and 4% on salary payments.

35. In Chart 11 the quarterly formation of the gross liquid holdings of the private sector during the last decade was related to the changes in the individual forms of short-term debt from which it arises i.e. to short-term borrowing by the Government, to the liquidity deficit of foreign countries and to borrowing by the private sector at the banks. It can be seen from the chart that its cyclical fluctuations were much narrower than those in its components.

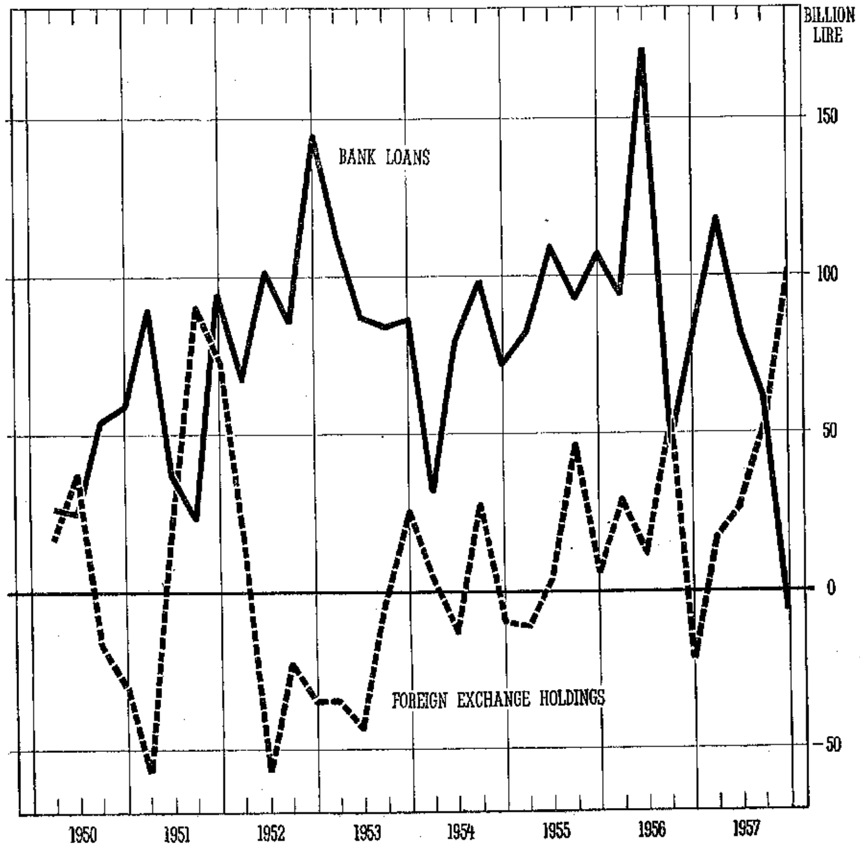
This fact is the result of the negative correlation between the movements of the components. Reference has already been made in the preceding section to the inverse relationship which existed in some periods (1949-June 1950, April 1952-June 1953) between the movement in Treasury borrowing from the central bank and the movement in the balance of foreign payments.

An analogous relationship of substitution may be observed between the variations in the volume of bank lending to the private sector and the foreign balance. This relationship came into sharp relief (Chart 13) in response to wide fluctuations in the balance of payments, such as those which occurred from 1952 to 1953 and from 1956 to 1958.

Since the balance of payments on current account is equal to the difference between saving and investment of the domestic sectors, the deterioration in the balance between the period July 1951-March 1952 and the period April 1952-June 1953 must be attributed to the fall in the savings-investment ratio which in fact took place (a) in the public sector and (b) in the business sector, and which was not offset by the rise that occurred (c) in the personal sector.

(a) In the public sector, the fall in the savings-investment ratio was due to the large expansion in investment outlays not financed by American aid, in current expenditures for raising the

CHART 13 - QUARTERLY CHANGES IN THE VOLUME OF BANK LOANS OUTSTANDING (SEASONALLY ADJUSTED) AND IN FOREIGN EXCHANGE HOLDINGS



salaries of Government servants, for social assistance, and for relieving unemployment, these last expenditures being classified on the margin between investment expenditures of minor usefulness and subsidies (No. 34).

(b) In the business sector, the fall was due to the decline in the volume and prices of exports, to wage increases, to the weak domestic demand for consumers' goods, to the high level of fixed

investments (undertaken in order to affront foreign competition after the liberalization of imports and in order to take advantage of the special facilities offered by the Government for financing imports of equipment), and, finally, to the rise in the prices of imported raw materials above the pre-Korean levels (No. 33), and to the involuntary accumulation of stocks in the warehouses of producers.

(c) The increase in saving in the personal sector was due to the marked improvement in wages and salaries (between 1951 and 1952 earnings among the relevant group rose by 10 per cent) and the lower propensity to consume after the buying wave of the first post-Korean year (35).

Looking at the movement in bank lending by itself, we should notice that, during the eleven year period which we have been examining, the cyclical variations in the net liquidity of the private sector resulted from opposite cyclical movements in the positive component consisting of bank deposits (36) and the negative component represented by borrowing from the banks.

The extent to which one or the other component reflects the movement in the foreign exchange position is obviously linked to the degree of dependence on bank credit of producing firms, and in particular of those which rely in large measure on purchases and sales abroad. In the case of Italy dependence on bank credit is especially high among firms engaged in the raw materials branch of the import trade.

It is also affected by variations in the distribution of liquidity within the private sector. Since the firms as a whole are net debtors of the banks while persons are net creditors (consumers' credit granted by the banks being an item of little importance) a shift of liquidity from firms to persons, such as occurred in 1952, has

(35) An analysis of the way in which sales of consumers' goods, wages, and other series that are indicative of liquidity conditions in the personal sector (currency in circulation, savings deposits) moved in relation to each other during the 1950/1953 cycle has been made by the present writer and by A. Occhiuto in one of the essays written in honour of Luigi Einaudi and published in the volume *Contributi all'analisi di alcuni fenomeni trattati nella relazione del governatore* (Servizio Studi Economici, Bank of Italy, 1954).

(36) The holding of Treasury notes is mostly confined to the banks and is thus of small importance as an element in the liquidity position of the private sector.

the effect of increasing bank loans and deposits at the same time (37).

36. The three years between mid-1953 and mid-1956 were marked by sustained economic growth without significant cyclical movements.

The first phases of the economic development policy have been mentioned in the preceding sections. They comprised: the formulation of the four-year programme submitted to the OEEC; borrowing from the IBRD for the development of the South, and the establishment of the *Cassa per il Mezzogiorno* (No. 29); the use of ERP funds and of foreign exchange resources for financing industrial investments; and measures for the expansion of employment (No. 34). Such a policy was finally given systematic form, in terms of a ten-year programme, at the beginning of 1955, when the Italian Government submitted to the OEEC projections of the development in employment and income, over the next ten years. This programme came to be known as the "Vanoni Plan" after the then Minister of the Budget. The targets of the plan were the maintenance of a 5 per cent annual rate of increase in the national product over the decade and a 3 to 4 million increase in the number of employed persons. These results were predicated upon the assumption of an increase in the gross investment ratio from 20.5 to 25.4 per cent during the decade (i.e. of a marginal investment ratio of over 30 per cent) to be obtained with the aid of a policy of wage restraint and massive capital imports. The document did not enter further into the policies and instruments which would be needed to implement the plan, except for the mention of the branches of activity (public works, public utilities, agriculture and building) in which Government action should be concentrated in order to provide the impulse to economic expansion. Vanoni died at the beginning of 1956 and his plan was never made more definite; however, it exerted in more than one way a positive influence on the course of economic policy and on the political balance in Italy. It created, at home and abroad, a more lively realisation of the

(37) Even changes in the distribution of liquidity merely between the firms have the effect of contracting or expanding bank assets and liabilities (cf. the two articles by E. LUNDBERG and B. SENNEBY, in *Skandinaviska Banken Quarterly Review*, July 1956 and January 1957). Unfortunately, in the case of Italy, information about inventory changes and the ownership of bank deposits is lacking so that we are unable to examine this effect statistically.

problem of economic development in Italy and of the duties deriving from it. It also created a certain community of purpose between a middle-class Government and the trade unions. It provided criteria for screening proposals for Government expenditure. By defining the aims of policy in aggregate income and employment terms, it helped the Government resist pressures for the protection of sectional interests. It did so more effectively than was the case under Fascism, when the emphasis had been on self-sufficiency and prestige. And it promoted efficiency more directly than a purely socialistic formula of equal shares and nationalisation would have done. By making clear the dependence of employment and productivity on investment it vindicated the social function of saving (38).

While continuing to provide a restraint against the deflection of Government policy away from the major aims set out in 1955, the plan has not evolved towards operationally more satisfactory forms.

It has not prevented a deterioration in the pattern of Government expenditure. The share of investment in the latter has continually decreased throughout the last decade in consequence of the more rapid expansion of several current items such as salaries, war pensions, assistance, defence, interest on the public debt. Investment expenditure accounted for 32 per cent of total expenditure in 1950/1951; its share fell steadily after that, reaching 17 per cent in 1957/1958 (39).

37. The ratio between borrowing by the public sector from the banking system and the financial market and borrowing by the

(38) On the last point, cf. L. EINAUDI, "Di Ezio Vanoni e del suo piano", *Prediche Inutili*, No. 2, Turin, 1956.

(39) On Einaudi's accession to the Presidency in May 1948, the office of Minister for the Budget was taken over by Pella, who held it until the end of 1953, when he was succeeded by Vanoni. The disruption of the tax collection system, the urgency of reconstruction needs and the sharp contraction of certain items of expenditure (such as defence and the servicing of the public debt) through defeat and inflation made, in the early post-war years, for a high deficit and a high proportion of investment expenditure. The gradual return to normalcy was marked by a diminishing deficit and the climb of current expenditure towards ever higher levels. Quite naturally, the limiting of the deficit under Pella, and the protection of investment expenditure against the swelling stream of current expenditure under Vanoni took, in turn, first place among policy aims. Both men fought against the main weakness in their budgets and their policies came to be identified not so much with the actual structure of such budgets, as with their efforts to improve it.

private sector from these same sources (40) fell from 1.1 in the years 1947/1948 to 0.55 in the period from April 1952 to September 1957.

Along with the shift of financing towards the private sector, there took place (No. 24) a relative expansion in the flow of long-term funds. This rose from 23 per cent of the total growth in financial assets in the years 1947-1948 to 50 per cent in the period from April 1952 to September 1957 (41). Among the components of this flow, that which grew most was bond issues by the special institutes for medium- and long-term credit and by the two State holding companies (IRI and ENI). This item constituted about a third of the total flow of long-term funds to the private sector in the years immediately following the stabilization; in the years 1954 and after it formed about a half.

The network of institutes which grant credit to industry and for public works, and which in the years immediately following the war consisted of three institutes of a national character and of the three autonomous sections constituted respectively by the two Southern banks (the Bank of Naples and Bank of Sicily) and by the Banca Nazionale del Lavoro, was gradually widened in subsequent years, with the creation, in 1947, of a bank-sponsored agency for medium-term credit, and, in the years 1952 and after, of a network of regional institutes (with a central rediscounting body) for loans to small and medium-sized industry. These institutes finance their operations by issues of bonds and with funds provided by the Government. At present there is growing up alongside them a second network of regional bodies (consisting of the autonomous sections of the mortgage banks) for financing public works and undertakings of public utility.

In fact monetary stability, by facilitating the marketing of fixed-interest bearing securities, has made it possible for Italy to consolidate and institutionalize that separation between short- and long-term credit business which was sanctioned by the Law of 1936 and which distinguishes Italian practice from that of other countries (42). It may be doubted, on the other hand, whether

(40) The first is taken as the sum of columns (1) and (3) in Table 7 and the second as the sum of columns (4) and (5).

(41) Ratio between column 12 and column 9 in Table 7.

(42) Especially France. Cf. A. Roux, "Long and Medium Term Industrial Credit in Italy", *Banca Nazionale del Lavoro Quarterly Review*, No. 41, June 1957.

it is wise to go on adding to the number of regional bodies. Not only are the conditions on which they can raise funds on the market less favourable than those which the large national institutions have succeeded in obtaining; but they tend to select the investments to be financed in a way which loses the advantages of an overall view without gaining those of a competitive system.

38. Between 1953 and 1956, the gross investment ratio rose without interruption from 20.2 to 21.5 per cent. The average annual increase in the national product in real terms was 5.5 per cent, with relatively small variations due in good part to the changing harvest results. The general index of wholesale prices (which in 1953 stood at 96.9 on the base 1948 = 100) was steady between 1953 and 1955 (the index being 96.5 in both years), and rose to 98.2 in 1956, in consequence of the poor harvest. The wholesale prices of manufactured goods fell between 1952 and 1956 by 8 per cent while those of foodstuffs rose by 10 per cent. The ratio between the money supply and the national product rose slightly (1956: 0.31; 1956: 0.32). The deficit in the balance of payments on current account went on declining: from 586 million dollars in 1952 to 450 in 1953 and 226 in 1956.

The period between the end of the Korean cycle and the disturbances caused by the Suez adventure is thus clearly distinguished by characteristics of stability with development in all the three fields, of production, the balance of payments, and prices. It thus differs both from the preceding post-war years, when there were moderate fluctuations in production about a rising trend and wide movements in the balance of payments and in prices, and from the years 1957-58, which were marked by a slowing down in the rate of growth in output and by large fluctuations in the balance of payments.

39. The preceding analysis, supplemented by other points, makes it possible to attempt a definition of the economic variables, and of some of the relationships between them, that have been at work during the period 1946-1958.

(A) *Factors Making for Development.*

(a) International aid made it possible to intensify, after more than ten years of rigid self-sufficiency, the utilization of domestically available factors of production, in the form of equipment and labour. A high proportion of the national income was devoted to investment purposes. This came about as the result of: 1) the normal effect of a rapid expansion in income (43); 2) the propensity to invest encouraged by the high yield (in terms of utility or profit) of investments for the reconstruction and repair of public works, buildings, productive plant; 3) the allocation to investment purposes of the counterpart funds. The large additional income flow meant that the high level of investment which generated it was reinforced in the manner indicated under 1).

(b) Government expenditure out of the budget became more heavily concentrated on investment as the outlays for the colonies, defence and the public debt declined. This was part of the general reorientation of Government policies towards aims that were defined in terms of domestic income and employment, and away from the old political ambitions.

(c) The achievement of better consumption standards and the fuller satisfaction of the basic needs for foodstuffs has caused a shift in the composition of marginal demand towards an increasingly large proportion of industrial products and a smaller proportion of agricultural products. In 1938 the income produced in agriculture was almost equal to that produced in industry. To-day the one is about 50 per cent of the other. The large role of agriculture in the formation of national income in 1938 meant that this phenomenon has been more important in Italy than in countries with a longer industrial history.

This structural change has tended to speed up the rate of increase in productivity and to create a " virtuous circle " in which the benefits of improved productivity are passed on to the workers in the form of wage increases and to the rest of the community in the form of reductions in the relative prices of manufactures — a factor which further promotes the shift in demand. The expansion in production, together with the population growth, made it easier and socially less disturbing to adapt the structure of production to the changing pattern of demand.

(43) The effect may be seen from the series of figures of the national product and of investment since 1861 published in the *Annali di Statistica*, series VIII, Vol. 9 (Istituto Centrale di Statistica, 1957). Cf. F. Di Fenizio, " La funzione del consumo in Italia come legge di lungo periodo ", *L'Industria*, January-March 1958.

(d) Italy is an exporter of " non-essential " goods, the demand for which is highly income-elastic. In the early post-war years, foreign demand was depressed by the fall in standards of living and by austerity policies. Rising incomes, and the gradual removal of controls on spending and on foreign trade have raised it much beyond pre-war levels. At the same time the maintenance of high levels of employment in many countries has attracted Italian immigrants and thus swollen the flow of workers' remittances to Italy. The high level of foreign demand, and the weakening of pressure groups after the downfall of the corporative state, made for less restrictionism in foreign trade and increased competition at home.

(B) *Factors Leading to Monetary Stability.*

(a) The development factors referred to under (A).

The high rate of income growth provided the means whereby considerable increases in nominal wages could be granted within the limits of the increase in productivity. Wages in industry, after a sharp upward movement (22 per cent) between 1947 and 1948, rose less fast than productivity and allowed the firms to pay dividends on the capital invested, to bear an increasing tax burden, and to lower the prices of manufactures, thus providing a counterweight to the rise in agricultural prices. The movement from the average monthly price level in 1948 to the level in November 1958 represents a fall of 8 per cent in the case of manufactures (semi-finished and finished products) and an increase of 6 per cent in the case of foodstuffs.

(b) The response to the experience of monetary stability which stopped capital flight abroad or into " refuge " goods.

(c) Monetary policy in its cooperating role (No. 40).

(C) *Cyclical Factors.*

(a) The three big cyclical movements of 1946/1949, 1950/1952, and 1957/1958 began simultaneously with the appearance of boom conditions on the international raw materials and freight markets. Alongside this foreign component there was in 1946 significant pressure towards inflation from a domestic source (lifting of the controls).

The amplitude of the inflationary swell was proportionate to the pre-existing liquidity situation and to the creation of new liquidity which took place during the process. In each case the latter led up to a situation of monetary stringency followed by a phase of recession associated with the reconstitution of liquidity holdings.

(b) The position which Italy occupies as a marginal supplier on markets which belong to preferential systems (Commonwealth and the French franc-area); the analogous position of Italy as a supplier of labour. Lacking protected markets, the Italian textile industry works at full capacity only in times of peak demand on the world market. Non-essentials almost invariably bear the brunt of import restrictions imposed for balance of payments reasons. On the labour market, Italy acts as a stabilizer for third countries, which invite or send back immigrants according to their own labour position.

(D) *Factors Dampening Cyclical Fluctuations.*

(a) The factors leading to monetary stability.

(b) The responsiveness of Government spending to the increase in the flow of funds to the Treasury in periods of recession.

(c) The anti-cyclical policy adopted in 1952 and, in more systematic fashion, in 1958.

(d) The importance of currency in the total monetary holdings. The currency holdings are mainly in the hands of the non-business public. This part of the public is less responsive to price movements and to opportunities for profit. At times of inflation, it absorbs cash in a manner which exerts a dampening influence on the inflationary process. For, this cash absorption, by decreasing the liquidity of the banks, reduces the coefficient of expansion applying to the funds available to the banks at the central bank (44).

(e) Investment in manufacturing, which responds cyclically to the mechanism of the accelerator, accounts for a smaller proportion of total investment than is the case in other more highly industrialized countries. Investment determined in accordance with long-term programmes (public works, agriculture and public utilities) or moving countercyclically (construction) accounts, on the other hand, for a large proportion of total investment.

(44) Cf. "Monetary Analysis in Italy", *Staff Papers* of the International Monetary Fund, February 1957.

(f) Lags between the domestic cyclical movement and the international one, meaning that, both in 1948 and during the early stages of the recession of 1951/1952, foreign demand acted as a factor helping to keep up aggregate demand. From November 1948 to September 1949, the same effect was exerted by the over-valuation of sterling.

(g) The variety of commodities entering into Italy's exports and imports. The intermediate position occupied by Italy in the process of transition from an agricultural to an industrial economy is reflected in the composition of her foreign trade. On the export side, a number of non-staple agricultural commodities, together with the products of their first processing, appear side by side with manufactured goods, while the latter still account for an important part of imports along with raw materials and basic agricultural commodities (cereals, meat and fats). When the goods are classified according to their end use, it appears that both consumer goods and capital goods enter largely the country's imports and exports.

The balanced composition of Italy's international transactions has a smoothing effect on the cyclical fluctuations in her terms of trade, which thus present a greater stability than those obtaining between highly industrialized countries (England, Germany) and primary producers (overseas sterling area), or than those confronting countries which specialize in the export of investment goods (Sweden, Finland, Belgium, Luxemburg) or of consumer goods (Denmark).

Moreover Italy's importance as an exporter of fruit and vegetables means that in this sector there is an inverse correlation between charges in supply (depending on harvest variations) and the prices reached; the consequence is that receipts are kept fairly stable.

(h) The position of equilibrium in the balance between inpayments and outpayments on account of freights: this tends to insulate the balance of payments from ups and downs in the most changeable of international prices.

40. In the eleven years from September 1947 to September 1958, the assets of the central bank — consisting of gold, foreign

exchange, and amounts due from the Government (45) and from the other banks — increased at an average annual rate of 13 per cent (from 796 to 3,030 milliards); and loans and investments of the other banks at an average rate of 20 per cent (from 950 to 6,800).

In exercising control over this rapidly expanding credit system the monetary authorities have made only limited use of the instruments described in the textbooks (discount rate, reserve requirements, open-market operations) and have preferred to rely on the less conspicuous and more flexible methods of action that were available to them within the Italian institutional framework (46).

The official discount rate, after it had been raised from 4 to 5½ per cent in September 1947, was brought down again first to 4½ per cent in April 1949 and then to 4 per cent in April 1950. It remained at this level until June 1958, when it was lowered to 3½ per cent. The rate for advances on Government securities, which had stood at 4½ per cent since 1938, was reduced to 3½ per cent in two steps (in 1949 and 1958). The statutory reserve ratios imposed in 1947 have been kept unchanged, except that in January 1953 eligibility for deposit as reserves was restricted to Treasury Notes, to the exclusion of longer-term securities. The Bank of Italy does not carry out large or frequent open market transactions; and there are no specific regulations governing stock market and consumer's credit.

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(45) Among the stabilization measures taken in 1947 was a decree, issued in December, enunciating the principle that no new advances could be made by the Bank of Italy to the Treasury without specific legislative provision. In late 1947 a new advance to the Treasury of 100 billion lire was authorized by *ad hoc* legislation. In May 1948, a statutory ceiling was set to the Government's overdraft on its current account with the Bank. However, Government borrowing from the central bank has taken roundabout ways:

(a) Through the investment of statutory bank reserves — either directly by the commercial banks or via the central bank — the Government shares automatically in the expansion of bank credit.

(b) By rediscounting wheat bills, the central bank has financed the losses of the collection agencies, losses which are a charge upon the Treasury.

(c) In the years between 1950 and 1954 the Italian Foreign Exchange Office surrendered to the Treasury foreign exchange to the value of 300 million dollars for the purpose of financing Government stockpiling and Government lending to the private sector. The Treasury's debt to the Exchange Office has been partly turned into Government securities which the Exchange Office has handed over to the Bank of Italy.

(46) Cf. " The Contribution of the Banking System to Monetary Equilibrium and Economic Stability: Italian Experience ", a lecture delivered by D. MENICHELLA, Governor of the Bank of Italy, to the Zurich Economic Society in February 1956 and published in the *Banca Nazionale del Lavoro Quarterly Review*, No. 36-37 of 1956.

But:

(a) The Bank of Italy has discretionary powers regarding access to rediscount facilities, to which no bank is automatically entitled, not even within predetermined ceilings. To the extent that the Bank uses these powers, central bank credit rationing takes the place of bank rate policy. Only " wheat bills " enjoy practically unlimited rediscount facilities.

Such powers also cover the extent to which the central bank will accept eligible securities as collateral for advances to other banks (and, of course, to private individuals and non-banking institutions, from which the Bank's facilities are being gradually withdrawn).

Advances and discounts to banks are, as a rule, granted liberally when it is a question of meeting local needs (for banks having widely scattered branches) or seasonal liquidity needs; but permanent financing of statutory reserves by the central bank is avoided.

(b) Individual lines of credit exceeding one fifth of the capital of the bank extending them are subject to Bank of Italy approval. Banking statistics, a special file for advances " in excess of the fifth ", information supplied by the Bank of Italy's branches, and cooperation with institutions granting medium-term credit, provide the factual and background material for the Bank's decisions in this field. This means that, although the evaluation of the business risk remains the responsibility of the lending bank, the central bank can take into account the general credit position and prevent undesirable uses of bank funds, such as the financing of fixed investment or of speculative stock accumulation.

(c) The central bank may influence, through moral suasion, bank operations not directly under its control, such as the use of foreign credit lines or the keeping of " free " deposits on current account with it.

(d) The lending of foreign exchange out of official holdings at proper times and for specified purposes has formed part of stabilization and development policies.

(e) Public issues of securities are subject to the approval of an Interdepartmental Credit Committee.

(f) The Bank of Italy heads the issuing syndicates that are formed for the flotation of new Government loans. The size of the issue is decided in the light of the current monetary position. The syndicate will establish the underwriting commitments of each bank and a set of incentive commissions and penalties designed to ensure their fulfilment.

41. The rules concerning the limits on Treasury indebtedness to the Bank of Italy and the policy followed by the latter in granting accommodation to the banks give to the supply of central bank credit an elasticity sufficient to meet seasonal and cyclical changes in the demand for money. Over the long period the additional demand for money due to the expansion of income has been satisfied through the investment of the statutory reserves of the banks and through the acquisition of official gold and foreign exchange reserves. The importance of these two components and the related change in the structure of the Bank of Italy's balance sheet during the decade 1948-1957 are shown in Table 8.

The high figure for the accumulation of foreign exchange may cause some observers to suspect that a deflationary pressure was exerted on the Italian economy during the ten-year period and that apart from the primary effect of the conversion of real resources into claims on foreign countries, there may also have been secondary effects tending to restrict the growth of income.

TABLE 8

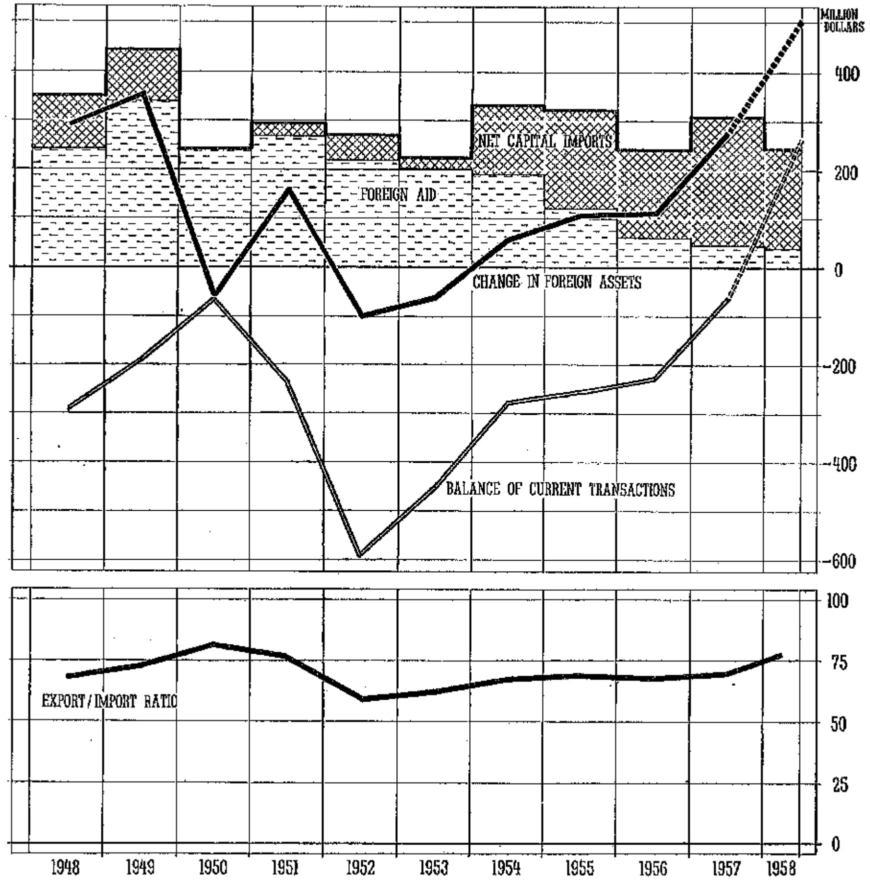
BANK OF ITALY: MAIN BALANCE SHEET ITEMS (1)

	End of 1947	End of 1957
	(billions of lire)	
Assets:		
Lending to banks	88	120
Discounts of "wheat bills"	100	380
Investment of statutory reserves	73	345
Other lending to Government	636	1,121
Gold and foreign exchange	49	719
Liabilities:		
Notes in circulation	788	1,914
Statutory reserves	73	545
Other deposits	55	61

(1) For more detailed analysis and definition of the items see *Bank of Italy Report for 1957*, Table 152.

This suspicion is not confirmed either by the monetary analysis given in the preceding sections, or by the movement of income and prices (except possibly in the year 1949).

CHART 14 - BALANCE OF PAYMENTS POSITION, 1948 to JUNE 1958



The contrast between the two diagnoses is explained by two considerations:

(1) The prevalence during the ten years of inflationary tendencies in the Western world.

Notwithstanding the system of fixed exchange rates, the additional demand for money due to the expansion of real income has modified the inflationary effect of the accumulation of foreign exchange.

(2) The amount of foreign exchange acquired was a little in excess of the net import of capital during the ten years, and equivalent to about 40 per cent of the sum of net capital imports and foreign aid (Chart 14). On some occasions to which reference has already been made the growth in foreign exchange reserves was held in check by the direct method of making foreign exchange loans to firms (47).

42. The Suez crisis provoked, in the second half of 1956 and the early months of 1957, an upward movement in prices and in freight rates and heavier buying, giving rise, in the case of Italy, to limited losses of foreign exchange reserves.

After the turning-point in the international cycle — which seems to have occurred in September 1957 — the improvement in the terms of trade and the drop in the quantity of imports turned Italy's balance of payments on current account in her favour.

The increment in official reserves of foreign exchange reached a new high level (700 million dollars in the twelve months October 1957 to September 1958). The present phase is characterised also by a fall in interest rates, both short- and long-term, and by the slowing down in the rate of growth in output (48), which is being combatted by a policy — initiated at the beginning of 1958 — of heavier spending in the public sector and the investment programmes

(47) Between 1948 and 1950, the Government has put at the disposal of industry for the financing of equipment purchases in Italy and abroad an amount equivalent to about 430 million dollars drawn from the official reserves of sterling (No. 28) and the lira counter-part funds of foreign aid. The funds thus lent were used for the most part to finance imported equipment (No. 28 and No. 33). The proceeds of the loan repayments were used for new financing; those from the loans made out of ERP funds being turned over to the *Cassa per il Mezzogiorno*, and those from the sterling loans being passed to the Central Institute for medium-term credit to medium and small industries (No. 34).

In addition the Government used 170 million dollars to finance stockpiling, and granted in the years 1951-1952 short-term credits, equivalent to 60 million dollars, in EPU currencies for financing imports of raw materials (No. 33).

(48) The growth of investments and of income during the years of Marshall Aid (1948-52) went further than, and the improvement in the balance of payments did not reach, the targets set by the four-year plan presented by Italy to the OEEC. Taking appropriate account of that experience the Vanoni plan fixed more ambitious income and investment targets, at the cost of what it foresaw to be a continuation of the deficit in the balance of payments over the entire ten-year period. Actual developments are at the present time once more diverging from the blue prints.

of Government-controlled enterprises as well as by incentives to private investment.

The decline in the demand for credit (No. 32) has induced the banks to add to their voluntary investments in Treasury Notes; at the same time the Bank of Italy has reduced the invested proportion of the statutory reserves.

The activation — which is desirable on other accounts — of the surplus liquidity built up after September 1957 may entail some losses of foreign exchange. Against the risk of such balance of payments swings, which are perhaps increased by the conditions of limited convertibility applying since the end of 1958, the lira has the backing of foreign exchange holding exceeding two billion dollars.

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