

# The Contribution of the Banking System to Monetary Equilibrium and Economic Stability: Italian Experience (\*)

## The Lessons of Four Experiences

The subject which I have chosen for this talk is « Italy's experience of the contribution of the banking system to the achievement of monetary equilibrium and economic stability ». In my country the formation of the complex structure of a unified modern economy took place in a relatively short time. The crises which inevitably accompany such a process of amalgamation and growth were over within the space of a few generations and, in the case of the banking sector, were more acute than in those countries where capitalism and the tradition of unity were of less recent origin. Only in one other recently-formed nation perhaps — the United States — have these crises been anything like as violent as those which have occurred in Italy.

These crises, however, were not suffered in vain; each one of them taught us a lesson and marked a decisive step forward in the development and improvement of the institutional framework.

Thus the first crisis of which I am going to speak, and which developed towards the end of the last century, involved, as the principal figures, the banks of issue and the institutions engaged in providing medium- and long-term credit; and it showed how serious can be the consequences of abandoning the principles of prudence by which both these types of bodies must necessarily be guided, if they are to function properly, in balancing the sources from which they obtain their funds, on the one side, against the manner in which those

funds are used, both as regards term and as regards risk, on the other.

Another crisis — which took place between the two world wars and which I shall briefly describe — provided proof of how necessary it is to intervene early and vigorously enough in order to nip in the bud incipient inflationary developments instead of allowing them to reach a more critical stage necessitating excessive repressive measures at a later date.

A later experience — the inflation in the second post-war period — taught us also that it is necessary, if the liquidity of the economic system is to be kept under control, that the bank of issue should be provided, in our country too, with certain means of action which had been tried out elsewhere. Thus the rational and practical character of the present system is due not merely to a detached clinical observation of the practices of other countries but also to actual operations carried out, in pain and suffering, on the body of Italy herself.

And finally still another experience, of very recent years, has confirmed the value of a rule of conduct which it might be extremely dangerous to abandon. I refer to the necessity of maintaining cordial and permanent contacts between the central bank and the commercial banks. Such contacts make it possible to keep a close watch on situations which, by their very nature, are constantly changing, and to correct undesirable trends early on, thus avoiding the necessity of frequent recourse to dramatic remedies, of which the aim and scope is not always correctly understood.

All these experiences, viewed together, give an idea of how difficult and delicate are the

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tasks of the central banks and of the commercial banks — or, in a word, of monetary policy — in trying to achieve and to maintain monetary stability.

### The Scope and Limits of Monetary Policy

In all cases it is only a contribution to stability that can be given. This needs to be said quite clearly, especially because, alongside those enlightened people who do not expect of monetary policy, which has finally come into its own again, more than it can achieve, there are some who, less well-informed and more impatient, expect of it things of which it is not by itself capable. And since the victims of these misplaced demands are very often the central banks, to one of which I have the honour to belong, I should like, before going on to recount the experiences which form the principal theme of this lecture, to take advantage of the present occasion in order to refer to another aspect of the subject of credit policy. I should like to draw your attention for a moment to the difficulties that are encountered by the central banks in regulating the volume of credit, and to explain how necessary it therefore is that they should meet with understanding in their work. For if we who belong to the central banks do not ourselves seize every opportunity of ensuring that the difficulties with which we are every day confronted are seen in the proper light, it is most unlikely that anyone else will, since it is, alas, the fate of the central banks to be without friends, as are all those who often say « No » and only rarely say « Yes ».

It so happens that the recent return to the use of the traditional instruments of monetary policy, following the neglect of so many years, has appeared to some as a new discovery, as is always the case when one political form is replaced by another — often its extreme opposite — in response to the innate human desire to make a « change ». The world which had grown accustomed to the system of fixed interest rates, usually kept low with the object of promoting full employment,

realised, quite suddenly, that this system might induce inflation or make it harder to combat — at the monetary level — an inflation due to other causes.

As is well known, the clarion call announcing the revival of these instruments of monetary policy rang out in the United States in March 1951, when the agreement was concluded between the Treasury and the Federal Reserve System concerning « the debt management and monetary policies to be pursued in furthering their common purpose, to assure the successful financing of the Government's requirements and at the same time to minimise the monetization of the public debt ». In Europe the revival reached a culminating point in November of the same year, when Great Britain once more had recourse to an alteration in its Bank Rate, which had remained practically unchanged at the level of 2 per cent for twenty years.

Because the traditional instruments had been forgotten for so many years, the return to them seemed to many people, as I have said, to represent a « new doctrine » and — what is more — an infallible remedy, sufficient by itself, to ensure the stability and the orderly development of an economy. This caused some people to forget, to gloss over, or to make light of, the conditions which ought to exist, but often do not exist nowadays, if these instruments are to be used with full effect.

The result has been a deterioration in the psychological climate in which the monetary authorities and, in particular, the central banks have to operate. It is essential to the performance of their task that the public should realise that in an economic system of which the movements are governed by a great many different but closely interdependent factors, it is extremely rare that the use of a single lever alone can achieve all the results desired. The reason is that there are nearly always present certain ineradicable factors working in the opposite, or at least in an unharmonious direction.

In particular, the central bank's task of achieving monetary equilibrium by means of the so-called « classical » corrective measures is made extremely difficult. And it frequently meets with almost insuperable obstacles of a psychological and technical nature if the policy of public spending simultaneously being pursued by the state, or by central and local government bodies, is such as to aggravate the conditions which the monetary measures are intended to correct.

Not infrequently, moreover, monetary disequilibrium is produced by major variations in the components of the balance of trade, attributable not to disparities between domestic and foreign prices — for such disparities are responsive to the influence of monetary policy — but to the sudden winning or losing of markets as a result of important changes in the particular conditions affecting certain exporting or importing countries. And as far as the general balance of payments is concerned, the corrective action of capital movements, which operated in the past, is now in abeyance almost everywhere, and the normal measures of monetary policy have not succeeded in bringing it back to life.

Monetary policy encounters particular difficulties, also, when it conflicts with wage policy. It sometimes happens that long periods of lull in the wage sector, or large and general wage increases, are due not to reasoned estimates of the level, or the rate of increase of productivity in a country, but to the behaviour of trade unions or entrepreneurs, actuated by various motives, not excluding political ones. In consequence the volume of demand may increase considerably when it ought to remain stable or to rise very little, and may thus cause an inflationary movement. Or, contrariwise, demand may fail to increase when productivity conditions would allow it to, with the result that a climate tending to induce a recession is created. It may be observed too, that a tendency towards inflation or recession that is caused by a disparity between labour productivity and labour earnings is certainly more difficult to combat by the use of mone-

tary instruments alone than is, for example, an expansion or restriction of market liquidity caused by balance-of-payments factors. In the first case, indeed, the discrepancy affects the whole of the consumer sector of the economy, and a very large number of individual budgets, whereas, in the second, the only direct and immediate effect is on the liquid resources of commercial banks and business units. It can, therefore, in this latter case be discovered and corrected before it has caused any more widespread development, or any sharp contraction in fixed capital investment.

It is often argued, moreover, and in perhaps too dogmatic or categorical terms, that at a time of full employment it is sufficient for monetary policy to bring about a little unemployment in order to check an incipient inflationary movement.

The reason why I am bringing up this point is not, of course, that it specially concerns Italy, where there is still, unfortunately, a great deal of structural unemployment. It is quite generally true that the application of the instruments of economic policy ought to give useful results without inflicting on people, be it only on a few, undeserved suffering. The problem must moreover always be considered in the light of individual circumstances, and of phenomena which may vary, in nature and intensity, as between different times and places. In particular, it must be borne in mind that trade-union policy sometimes tends to overlook the question of the level of employment. Thus insistent and unreasonable demands for increases in wages may be made even in situations where full employment does not exist. Not infrequently, indeed, the pleas advanced and the pressures applied by those in employment prevail, within the sphere of the trade-union organisations, over and against the claims of the unemployed. It may also happen that, given the high degree of specialisation among wage-earners in modern economies, an indiscriminate policy of raising the cost of money, or, more generally, of credit restriction, will leave large sectors of production in a state of full employment

without the wage level in these sectors being affected by the increased unemployment in others.

Another difficulty encountered by monetary policy comes from the fact that the investment decisions of industrialists are influenced first and foremost, and perhaps predominantly, by their firms' own possibilities of self-finance. Only to a subordinate extent, and very indirectly, do they depend on the changing terms on which the commercial banks grant short-term credit, the form of accommodation which is usually most rapidly affected by movements in the discount rate, by the use of open-market policy and by changes in compulsory reserve requirements. Moreover, once a largescale programme of investment in new industrial plant has been started, it is difficult to stop it before completion, so that in such a case a change in monetary policy is very slow to take effect.

The methods of monetary policy and of central-bank action in general cannot therefore be rigidly systematised, nor can they always be fully effective. One need only think, here, of the difficulties, the misery, and the loss of wealth which may follow a policy of attempting to force an equilibrium in the market by endeavouring at all costs to maintain the exchange rate of the domestic currency in terms of foreign currencies, as was done in Italy in one of the « experiments » I shall describe later on, and in a number of other countries in the course of the past thirty years.

For the reasons I have mentioned, and also because the instruments of monetary policy have only recently been restored to a place of honour, these instruments have during the last few years held a central position in discussions among economic theorists, among those concerned with practical economic policy, and between these two groups. These discussions have naturally dealt with the nature of the instruments, the conditions under which they can operate more or less effectively, and the results which they may be expected to achieve. There have thus been lively debates concerning the powers of the central banks

vis-à-vis the action taken by the respective treasuries, and concerning the relationships which should be established between these two bodies. The question has been discussed of whether they should both be autonomous to the point of ignoring each other's existence, or whether each should retain the ultimate right to make independent decisions though working together on a basis of permanent co-operation, and if so, what possible forms such co-operation might take.

Equally animated and interesting were the debates concerning the relations between central banks and commercial banks, the powers which should be given to the former and the duties which should be assumed by the latter, the question of whether these powers and duties should be defined by law or merely be subject to administrative regulation, or whether, finally, the co-ordination of their activities should be the result of action inspired by mutual goodwill and free from all constraint.

All this is well known to you and I do not intend to express any opinion in favour of one or the other of these theses, least of all on the present occasion. For I am bound by my regard for the country whose hospitality I am enjoying, and in which, particularly since last summer, these discussions have assumed important proportions in terms of a special local situation. They have been especially stimulated, that is to say, by the high degree of liquidity which has been a feature of the Swiss market and by the considerable afflux of monetary resources to the reserves of the Confederation.

I am sure, however, that these discussions will bear fruit, just as sincere and thoughtful examination of any important problem is bound to lead to useful results. For some years now there has been a general realisation that the progress achieved in understanding the nature of economic phenomena, particularly in the monetary sphere, has helped and will certainly help in the future to mitigate the severity of crises compared with those of the past, so that it is probable that there will be no further depressions as intense and as

prolonged as that of 1929. It seems certain, therefore, that within a few years our knowledge of how the instruments of monetary policy can be used to best effect will cause us, in the particular instances as they arise, to be more single-minded in our choice of action, to reach our decisions more quickly, and to put our instruments to better use.

In studying these problems we shall be able to profit not only from the progress which is being made and will go on being made in the field of scientific research, but also of the increased knowledge now available of various countries' experiences in monetary matters under different economic conditions.

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In passing on to my brief illustration of the role of credit policy at various periods of Italy's economic history, I fully realise, of course, that in all countries the study of credit problems both in theory and in practice has made great advances in the last few years, so that past events, especially when they lie as far back as some of those which I am about to describe, can be of but little help to those who are called upon to operate in this sector of economic life to-day.

But even little streams make great rivers. I feel, therefore, that it is not a waste of time to try, as I shall do, to high-light the similarities and dissimilarities, however small, between problems of the past and those of today. I hope, at least, that I shall succeed in showing, if only by the law of opposites, that events support my conviction that the corrective instruments of monetary policy, though not always completely effective, can often achieve very useful results, especially if they are applied in time and in sufficient strength, and especially also if the central bank's task is facilitated by the existence of good relations and a spirit of co-operation between it and the commercial banks. Whether central banks have complete and clearly-defined responsibility, as in some countries, or a more limited and less obvious rôle, as in others, the

burden they have to shoulder in endeavouring to maintain monetary equilibrium and economic stability is a heavy one.

### The Boom of the 1880's and the Crisis of the '90s

The first experience which I should like briefly to describe has, one might say, an archaeological flavour.

It took place before most of us were born. If I refer to it at all, it is only in order to give you an idea, by way of comparison, of the great progress which has been made in some seventy years in the system of granting credit and in the organisation of the central banks. It will not be possible, of course, for you to learn from what I shall say anything that might be valid today regarding the use of the instruments of credit control. My story will merely provide further proof of the unfortunate results which may ensue from a rash credit policy and from acute rivalry between banks.

In the years 1880-1893, the period in which the events I am relating occurred, there were in Italy no less than six banks of issue, all in fierce competition with each other. The newly-achieved political unity of the country had not yet affected the organisation of the monetary system. Self-interest and misplaced considerations of prestige on the part of the various regions, which had formerly been independent states, were, in fact, destined for another third of a century to prevent Italy from establishing a single central bank.

On the slender basis of a generally poor agricultural economy and at a time when world-market prices were slumping, people in the new capital began feverishly to put up numerous large office buildings and dwellings to house a population which was growing so rapidly that it was to double itself in less than twenty years. To this excessive building activity was added the burden of railway construction and of military outlays for the Eritrean campaign.

A large proportion of the necessary capital was borrowed abroad. As a result of the tabling of a bill introducing convertibility of bank-notes into gold, the premium of gold over bank-notes dropped from 9-13 per cent in 1880 to 0-3 per cent in 1881. Though this appreciation of the lira naturally led to a worsening of the balance-of-payments situation on current account, it greatly encouraged the flow of foreign capital into Italy. Part of this took the dangerous form of short-term inter-bank credit (overdrafts, rediscounts of commercial bills, and contango operations in securities). This influx of private capital has been put at some 500 million gold lire, equivalent to about 5 per cent of the annual national income at that time; in relation to the present national income, this percentage would represent one milliard dollars. To the influx of private capital was added a roughly equivalent amount of gold which the Italian Government received, at the time of the restoration of convertibility in 1883, as a result of the placing on the London market through Hambro's and Baring's of a large 5 per cent loan issue. Further public loan issues were placed abroad during the following years, so that at the end of the crisis I am describing, that is, in about 1894, the external public debt amounted to some 1,700 million gold lire (1).

Of the large volume of monetary metal acquired by means of these foreign loans part was absorbed by the active circulation, and part went to increase the reserves of the banks of issue, thus enabling them to undertake a credit expansion to which they were encouraged by the spirit of mutual competition. Discount operations, which had amounted to 2.5 milliard lire in 1884, rose to 3.6 milliard in 1885 and to 4.4 milliard in 1886.

(1) The total inflow of gold from abroad, estimated at 2,200 million lire of that time, would correspond, after allowing for the increase in the price level, to about 7 billion Sw. frs. of to-day. Since Italy's national income at that time was equal, in real terms, to one third of the present one, the magnitude of a capital movement of the same significance for the country to-day would be roughly equal to 21 billion Swiss francs.

The additional operations were mainly of the nature of real-estate credits, building credits and stock-exchange credits granted to speculators, aside from operations, which though less abnormal were also influenced by the business boom, such as import credits. Between 1883 and 1887 import credits increased by about one-quarter, while exports decreased by more than 15 per cent.

The rush to buy land and building plots had become spasmodic; the prices of land bought with the aid of borrowed funds increased in many cases by as much as fifty times in the space of a year or two!

At the beginning of 1887 there was a change in the trend. On top of the depressed conditions in the agricultural sector, which was unable to pay off its bank debts, and the difficulties which had arisen in trade with France, there came the collapse in quotations on the Paris Stock Exchange, which also involved Italian Government securities which had been placed on that market. The result was a general movement by foreign banks to withdraw their capital, so much so that the Italian banks, which were obliged to pay up, suddenly found themselves without funds to continue the financing they had undertaken to carry out, particularly in the building sector.

After a few attempts had been made to save the situation, several banks collapsed under the weight of the withdrawals of deposits. Among them were two institutions which were giants of their day: the « Società generale di credito mobiliare italiana », which had been modelled on the similar French institution (the « Crédit mobilier »), and the « Banca generale ». The most important concerns in the country, ranging from the railways to building contractors, and from the steel mills to farms, had relied on these banks for their financing.

The heated discussions which ensued made it impossible at the time to examine objectively what had really happened; and many leading bankers were even cleared of all blame, being regarded as the victims of the perfidy of others.

Few people realised that the main cause of these events was the abandonment by the banks of issue, by the banks granting medium- and long-term credit, and by the ordinary commercial banks, of all the rules of prudence, and their unrestrained competition with each other to obtain deposits and financing contracts.

It took a long time, some fifteen years in fact, for the effects of the crisis to be worked off; and the banks of issue themselves suffered substantial losses. The losses were heavy even though the realisation of assets took place at a time when conditions had become very favourable for Italy, as for other countries. In that first decade of the twentieth century, in fact, world prices, which had been sinking in the previous thirty years, began to move upwards again, partly as a result of the working of the Transvaal gold mines.

#### The Inflation of the 1920's

Another unhealthy economic episode was the inflationary movement which lasted, with a few short interruptions, from the autumn of 1924 until August 1926 and which was again followed by an acute depression. This episode was largely due to the easy availability of bank credit, to the abuse of short-term financing for the purpose of covering the budget deficit, and to the absence of instruments of control such as compulsory reserve requirements, which were unknown at that time.

An idea of the extent of the inflationary movement which took place at this time is given by the fact that between December 1923 and August 1926 wholesale prices rose by about 30 per cent and the cost-of-living index in Turin and Milan by 32 per cent. There was also a rise in the index of money wages, but, as usually happens when a rapid inflationary process is under way, this increase fell short of that in the cost of living. Thus, for example, the wages paid in certain industries in Milan went up by only 26 per cent. All this happened six years after the end of

the war, and following four years of relative price stability; in some sectors, indeed, there had even been a decline in prices.

From the external point of view, this period was characterised by a substantial depreciation of the lira. The dollar rate rose by about 20 per cent between October 1924 and July 1925. Subsequently the authorities intervened vigorously in order to check the rise, but as soon as intervention ceased the rate jumped up by 27 per cent in the short space of three months, from the end of April to the end of July 1926.

The inflationary movement was certainly not caused by any large budget deficit — in fact there were budget surpluses in the two fiscal years 1924-25 and 1925-26. Nor was it caused by the monetisation of balance-of-payments surpluses, for in 1925, the middle year of this period of difficulty, imports actually increased by 35 per cent and the trade deficit by 58 per cent.

The period was on the other hand, one of high production and heavy investment activity: the productive capacity of many plants was utilised to the maximum, steel output was higher than in the most feverish period of the war, and the construction of hydro-electric power stations and of roads was proceeding at an extremely rapid rate, with the result, *inter alia*, that the demand for cement ran ahead of supplies despite the continual rise in prices.

The total nominal capital of the joint-stock companies increased by 55 per cent in the two years 1924 and 1925; and the index of share quotations rose by 70 per cent in the 14 months from December 1923 on. Unfortunately no complete statistics are available for bank credit; but the annual balance sheets of the principal banks reveal that the item « saldi debitori » (under which overdrafts are included) expanded by 32 per cent in 1924 alone.

What was the basis which had enabled the money and capital market to develop to such an extent as to allow a movement of general recovery and expansion in production to turn

into a boom of such unhealthy dimensions that — as I have said — the total capital of all joint-stock companies increased in two years by 55 per cent and the volume of bank lending rose by 32 per cent in one single year?

The answer is that the banks of issue had greatly expanded their lending operations during the period in question, and that large amounts of Treasury bills and certificates were cashed in by the banks and by private investors. In the case of the Banca d'Italia alone the average annual total of discounts and advances outstanding rose from 4.7 milliard lire in 1920 to 8.5 milliard at the end of 1921, 9.3 milliard at the end of 1924 and 11.7 milliard at the end of 1925.

What happened was not, however, due to any course of action voluntarily adopted by the banks of issue. Their action had been dictated by the necessity of limiting the effects of a serious banking crisis which had broken out towards the end of 1921. One of the country's four big commercial banks had gone bankrupt as a result of a run by depositors, and this event had led in turn to substantial withdrawals from certain other banks. In order to make possible at least partial repayment of the depositors of the bank which had collapsed, pending the liquidation of its assets, and to sustain other banks which were in a precarious situation, the banks of issue had to intervene.

The resultant large injection of new cash led to a considerable flow of funds to those banks which had not been affected by the crisis, and this had the effect of widening their lending potential. This in turn gave an excessive impetus to productive activity and meant that the available physical resources were no longer sufficient to meet the demand, so that prices began to rise rapidly; and this movement was sustained — instead of curbed as it should have been — by the action taken in the field of credit. The process was aided by the monetisation of Treasury certificates which had been taken up by the banks and by private individuals during the first post-

war years when they were issued to finance the large budget deficits.

Recourse was had to measures of intervention on the Stock Exchanges, a margin requirement of 25 per cent being introduced for security purchases. Changes were also made in the official discount rate, which was raised three times — altogether from 5 1/2 to 7 per cent — in the space of a little more than three months. After the Treasury Minister who had been responsible for these measures had been replaced, they were not pushed further, and perhaps this was one of the reasons for which they proved inadequate. It seems proper to conclude that the nature, the magnitude and the causes of the phenomenon which had occurred, would have called for a bold application of the methods which are most suitable for the sterilisation of excess market liquidity: i.e. the creation and sale of substantial quantities of long-term government securities or the imposition of high compulsory reserve requirements, such as would have reabsorbed the large volume of cash which had been created as a means of facilitating the liquidation of the bank that had failed and of preventing others from failing. But these means of action were unknown at that time in Italy, as they were, indeed, in many other countries too. The boom came to an abrupt halt in August 1926 and turned into an acute recession as a result of a change in the psychological attitude of businessmen and traders. For these had been struck by the firm determination shown by the Government towards the end of the same month to oppose any further decline in the purchasing power of the currency and, above all, by the measures adopted to block the issue of bank-notes, and compulsorily to convert into long-term securities the very large volume of short- and medium-term Treasury certificates outstanding, of which the medium-term ones were about to fall due. This consolidation affected Treasury certificates to the value of more than 20 milliard lire, corresponding to about 1,200 milliard present-day lire, or 2 milliard current dollars. All the market's liquid reserves having thus been

mopped up, there was a severe restriction of credit, and this had the effect of sapping the nation's powers of resistance to the world crisis of 1929.

These were extraordinary events, events which perhaps could not have occurred elsewhere, since, as we have seen, they were essentially due to very large-scale financing by the banks not of short-term commercial loan operations but of operations which were of quite a different kind, and to the abuse of short-term financing by the Treasury.

It is true, of course, that banks of issue also intervene, though generally on a smaller scale, whenever the afflux of foreign capital to a country assumes abnormal proportions, or when an export boom occurs as a result of exceptional circumstances in countries where the bulk of the foreign exchange assets are held by the banks of issue themselves or by bodies financed by them. And a state of excessive liquidity may also come about as a result of a rapid amortisation of the public debt or the failure by subscribers to renew their holdings of government paper.

This brief description of events in Italy shows how limited is the effectiveness, in such cases, of changes in the discount rate. And it makes one realise that in these cases it is necessary, as I have said, to take direct action to reduce the volume of available resources by mopping up excess liquidity through a bold open-market policy or by the strict application of high minimum reserve requirements to the banks — or, perhaps better, by the use of both methods together, so that not only the banking system but business firms and private individuals as well may be affected.

#### The Stabilization of 1947

I also have to say a few words about a further development which has been of great importance for my country. At the time when it took place the credit system was undergoing the serious difficulties by which the whole Italian economy was beset less than

two years after the end of the second world war, and the corrective action then taken laid the basis for Italy's present monetary policy.

I refer to the action taken in the second half of 1947 to call a halt to the open inflation which had then been particularly virulent in Italy for about the last year. This event is well known and has been the subject, both at home and abroad, of such thorough and detailed studies that I need now only recall the salient points of the situation in which it arose. I shall then have a few moments left in which to give a brief description of still more recent monetary events which have brought the further development of the principles of action underlying the measures taken in 1947.

There is no doubt that the 1946-47 inflation in Italy was due to a marked disequilibrium between, on the one hand, the excessively large volume of liquid resources which had been accumulated, during the war and immediately afterwards, both in the economic system in general and in the credit system in particular, and, on the other, the small amount of physical resources available for economic reconstruction. The disequilibrium was aggravated by the poor crops of 1947, by the paralysis of large sectors of the railways and of the system of maritime transport — one of the most serious effects of the war — and by the inadequacy of power supplies.

As a result of the running-down during the war of the normal stocks of raw materials and finished products by industry, trade and private consumers, the volume of discounts and advances had fallen to only 25 per cent of total bank deposits; a portion of the remaining 75 per cent was invested temporarily in Treasury bills and other government securities, but the greater part was held in the form of cash or sight funds with the central bank.

The provision of the financial backing for the reconstruction of the country could therefore be assisted, as in fact is was, by the large unused lending potential of the banking sys-



tem. In the first few years after the war the banks were, moreover, receiving a large and constant flow of bank-notes, coming from the exceptionally large holdings of the public. For, particularly during the last few years of the war, Italian citizens who had left their homes to take refuge from the air-raids had accumulated, as an easily transportable personal reserve, large amounts of bank-notes which, as soon as peace was restored, they once again deposited with the banks.

The nation's determination to undertake the rapid reconstruction of the country, backed by the strong spirit of initiative and enterprise which has never been lacking in my compatriots, thus derived considerable financial support from the high degree of liquidity of the banking system. At the same time, however, it came up against a serious difficulty in the form of shortages of raw materials and foodstuffs, together with a number of other obstacles created by the wartime destruction of the means of transport and by the deficiency of power supplies.

These disequilibria inevitably led to a rapid rise in prices, since everyone sought to obtain at all costs the means of production and goods available.

Such a process, provided that it is not stimulated by further inflationary injections of funds into the economy by the Treasury or the central bank, is bound to come to an end in due course through the re-establishment of equilibrium between the volume of money and the price level on the basis of the available supplies of goods. In 1947, however, only one of the two conditions referred to above was fulfilled in Italy. For, though the central bank abstained from creating any additional purchasing power by way of its normal operations, the Treasury was running a very heavy deficit and had recourse to the bank of issue for accommodation. In the financial year from July 1946 to June 1947 the payments made by the State were almost double its receipts, without allowing for the large expenditures that were obligated during the year

and not yet paid. It was not possible to increase tax revenue despite the goodwill shown by tax offices, which had been disorganised by the war and which inflation, either by altering the monetary yard-stick or by bringing about rapid changes in private incomes, had gradually deprived of the very basis for their assessment of taxable incomes.

Finally, even if the stimulus to inflation deriving from the recourse which, despite the successful placing of certain public loan issues on the market, the Treasury still had to the central bank for financing its deficit, had not existed, it would have been inadvisable to wait passively for the restoration of equilibrium between the money supply and the price level. Two factors counselled more positive action: one was the impossibility of foreseeing under what conditions and at what price level such an equilibrium would be re-established, and the other was the rapid decline in the foreign exchange reserves. The suffering inflicted on the general public by inflation would certainly have been increased by a further period of waiting and might have led to violent and uncontrollable social unrest. In addition to the action taken by the government in the form of issues of loans, the reorganisation of the fiscal system and the restriction of expenditure, it was also necessary to take resolute measures to sterilise a large part of the liquid resources held by the banking system. Such measures were taken in the summer of 1947, when the compulsory reserve system was revised and the new rules were strictly enforced.

Italy's experience has proved that, under certain conditions, even a very strong appeal from the central bank to the commercial banks is not sufficient. For since January 1947 the central bank had in fact strongly urged the commercial banks to limit their lending operations. These admonitions from the central bank were not very effective, for two reasons probably. One was the extent to which inflation had spread. The other was the fact that no bank likes to appear too

clearly to be taking steps to restrict its lending unless it can show that other banks are following the same course, for fear that it may be considered to be in a weaker financial position than its competitors or that it may lose the goodwill of its customers. In the spring of 1947 the inflationary movement became particularly pronounced on the stock exchange, where there was a very rapid rise in quotations. This development was reflected, especially in the summer, in the brisk competition for imported raw materials and finished products, with the result that foreign exchange reserves fell to an extremely low level despite the full utilisation of the American aid received by Italy.

It was not until August of the same year that it became possible to set up an inter-ministerial committee endowed with adequate powers of control over the credit system. Once the executive powers had been entrusted to the central bank, new rules concerning the holding of compulsory reserves by the banks were worked out and immediately put into application. Thus the inflation was brought to a speedy end.

The slowing-down of the rate of bank lending as a result of the blocking by the central bank of the banks' liquid resources and of the requirement that the banks should tie up, at the central bank or the Treasury, a large proportion of their new deposits, led owners of commodity stocks to offer them for sale. This caused, first, a halt in the price rise and, then, a fall in the prices which had risen most (i.e. those of foodstuffs) and a decline from the peak prices which had been reached in some other sectors in the last few months. Moreover, many firms which had based their development plans mainly or entirely on expectations of the availability of additional credit facilities or of further price rises had to revise those plans.

The rate of production declined, as was natural, but the contraction was limited in amount and duration. Within six months production had begun to go up again — this

time on a sound basis, that of a healthy currency.

At this time Italy avoided two errors which might have transformed the preceding strong inflationary movement into a no less serious and prolonged recession.

When an inflationary movement is stopped or slowed down, there is a sudden fall in the velocity of circulation of money, as the public once more begins to hold on to bank-notes. If the money supply thus becomes inadequate, the result is not merely a halt in the price rise but an actual fall in prices, which may turn out to be neither negligible nor of short duration. The movement then becomes continuous and is intensified by the reluctance of the public to buy anything which is not strictly indispensable; this in turn leads to a reduction in activity in many enterprises and to the spread of unemployment.

In 1926-27 these considerations did not influence the government then in office, which wanted above all to see the success of its effort to arrest inflation actually reflected in the stabilization, or even in the reduction of the volume of bank-notes in circulation, and took every possible step towards this end. The result was a downward price spiral which, even though it was accompanied by some reductions in wages, caused economic difficulties which have still not been forgotten by my fellow citizens and which, as I remarked earlier, added in Italy to the difficulties which were brought a few years later, to every country, by the world depression of 1929.

It was because they had profited by this experience that the Italian monetary authorities did not take fright at the rapid increase in the note circulation after the measures of August 1947. In 1948, while the wholesale-price and cost-of-living indices remained stable or even showed a slight tendency to decline, an increase of as much as 22 per cent occurred in the Banca d'Italia's note circulation; whereas in more recent years — from 1952 to 1955 — the average annual increase has been only 6.8 per cent, despite the substantial and continual growth in the national income.

The second mistake which was avoided in 1947 relates to the nature and the effects of credit restriction.

It is often claimed these days that the banks do not apply credit restriction in an « equitable » manner, since the measures taken by them are of a general nature and it may thus happen that their best customers are favoured at the expense of those who are less good or less influential.

There is a good deal of truth in this criticism, although the fact is often overlooked that to-day the best and most powerful enterprises are almost everywhere practically self-sufficient financially, and have relatively little recourse to bank credit. This was not, however, the situation which prevailed in Italy in 1947, and there was a very real danger that the slowing-down in the rate of increase of bank credit, at which the measures taken in August were aimed and which they in fact achieved, would, in the case of many enterprises, actually lead to a reduction in the volume of credit at their disposal. In particular, many sectors of the engineering industry were in a critical position at that time, since, after having worked to full capacity during the war, they were now passing through a difficult stage of the adjustment of their production to civil requirements. It was thought that the needs of these enterprises might be disregarded under the new tighter credit conditions, and steps were consequently taken to create a government fund to provide finance for the engineering industries. This fund, called the « Fondo Industrie Meccaniche », carried out, in a very short space of time, lending operations totalling 35 milliard lire (60 million dollars). Since the process of its liquidation began a few years ago it has recovered part of the funds lent, and is at present collecting that part of the remainder which is still recoverable. This was the price which had to be paid in order to overcome the objections — which were many — of those who saw in the monetary measures adopted, the destruction of the illusion they

had created for themselves that prices would go on rising indefinitely.

The events just described help to demonstrate that measures of a monetary nature do not in themselves have any absolute validity, and are not universally applicable at all times and in all economies. The wisest policy, therefore, is to apply them with the degree of vigour and flexibility which seems to be called for by the technical, political and social conditions prevailing in the country concerned.

### The Experience of the Last Few Years

As a result of the measures taken in the autumn of 1947, a close bond was established between the central bank and the commercial banks, especially the larger of these. Care has been taken since that time to preserve this link, and to strengthen it in various ways whenever developments in business conditions have tended to make it weaker.

The instruments used are of various kinds. The central bank can allow or refuse the commercial banks rediscounting facilities and advances on securities. The Italian Foreign Exchange Office, which, in turn, is financed by the central bank, may grant or refuse the commercial banks loans in foreign currencies. The banks can be requested to be more liberal, or more sparing, in their use of credit facilities granted to them by their foreign correspondents, especially American or British banks. The central bank can apply, with varying degrees of liberality, its powers to authorise the commercial banks to grant credits which exceed a certain percentage, fixed by law, of their share capital and reserves. Finally, a constant watch is kept on the level of the funds held by the banks in the form of free or tied deposits at short term (eight or fifteen days) with the central bank.

In this last respect it is perhaps not without interest to note that the experience of the last few years has taught the management of the central bank, and the managers of the commercial banks, a great deal about the magni-

tude of seasonal movements in the cash position of the banks, so that they are able to recognise quite easily phenomena which are at variance with what experience has led them to expect.

The use of the instruments which I have described, and the constant contact maintained between the central bank and the commercial banks, especially the larger of these, in order to induce them appropriately to control the volume of their liquid resources, independently of the application of the rules concerning their reserve requirements, has been supplemented since 1950 by the issuing, in the early months of each year, of nine-year government bonds, the so-called « Buoni del Tesoro Novennali ». These bonds, which are placed on the market by the credit institutions, serve to absorb the excess liquidity which usually appears in my country towards the end of the year. And the placing of them tends to neutralise the inflationary effects which would otherwise be produced by the budget deficit. Other government issues have been launched in recent years, largely with the same object, whenever it has seemed opportune. These have been mainly 20-year bonds issued for the purpose of providing the state railways with the funds needed for improving their equipment.

Since it is the central bank which, in Italy, handles all in-payments and out-payments on behalf of the government, the repercussions of movements in the Treasury accounts are directly felt by the central bank. Being in close contact with the market through the commercial banks, the central bank tries to offset the effects which may ultimately be produced on the market as a result of the operations of the Treasury combined with those of the commercial banks.

Lastly, the central bank, acting in its capacity as the executive organ of the Inter-ministerial Credit Committee, gives this body its views on issues of shares and bonds which industrial, commercial and financial companies, and long and medium-term credit institutions propose to launch. In this field, too, an

examination of the liquidity position may justify, as an auxiliary policy measure, action aimed at preserving or restoring the financial balance of a market which, in Italy, has over the last few years always been extremely active so far as investment is concerned. Indeed the limiting factor here has come, and still comes, primarily, from the necessity of maintaining equilibrium in the balance of payments.

The instruments for limiting rediscounting and advances were used with particularly marked effect during the Korean crisis of 1950-51.

Under the Italian system regulating the relations between the central bank and the commercial banks there are no fixed ceilings up to which the commercial banks are entitled to draw on the central bank for funds. It was thus possible in the very first months following the outbreak of the war to take fully effective action to limit the rush which, in Italy as elsewhere, had started among consumers, producers and traders to pile up stocks.

The central bank, to which, as I have said, have to be submitted all applications for the granting of credit to any one firm in excess of a certain fixed percentage of the capital and reserves of the bank in question had, therefore, at that time two instruments at its disposal. It had the power to expand to a greater or lesser extent the volume of rediscounting facilities and of advances; and it had the power to grant or refuse permission to increase the amount of large individual credits. It used both these instruments. It allowed the commercial banks to be more liberal in the granting of credits that were to be used to finance imports of raw materials and finished products, but it was very strict as regards the accommodation it was ready to give the banks in the form of discounts and advances, keeping this far short of the amount that was requested. The result was a tight credit situation which implied, of course, a marked slackening in the rate of increase of bank deposits — both on savings and on

current accounts — which had until then been high. The final outcome, however, was that prices were prevented from soaring upwards. Domestic prices, in fact, rose only moderately, so that Italy may be counted among the countries which, after the events in Korea, succeeded better than most in checking the depreciation of their currencies.

Between July 1951 and September 1952 Italy went through a phase of high liquidity. This was due in the first instance to the very favourable trend — which lasted until March 1952 — in the export trade. This was in turn primary attributable to the heavy sales abroad of textile goods, which were in particularly strong demand in those overseas countries which had rapidly increased their foreign exchange earnings as a result of the sharply increased prices of the raw materials which they produced. In the course of 1952 the liquidity of the market was further swollen by a rise in budgetary expenditure and larger outlays for workers' old-age pensions.

Such additional rediscounts and advances as had been granted — even if their amount was modest — in the preceding phase of credit shortage which I have just described were not renewed and steps were taken to persuade the principal commercial banks to exercise restraint in the granting of fresh discounts and advances to customers. Nevertheless, despite the normal annual issuing of long-term Treasury bonds, the banks' liquidity remained very high, and it was feared that it might give rise to an excessive expansion. This danger was, however, forestalled mainly because at that time world-market prices were continually moving downwards.

A day-to-day watch was kept on the situation and the central bank would not have hesitated to intervene by raising compulsory reserve requirements if there had been evidence that its appeal to the commercial banks was not being heeded.

From 1953 up to the present time there have been no disturbances of note in the economy. The excess bank liquidity of the preced-

ing period had been gradually absorbed as a result of the moderate expansion of credit which, on the basis of an improved balance-of-payments position, accompanied the increase in investment activity associated primarily with the programme of developing southern Italy. The ratio between the liquidity reserves and deposits of credit institutions was in consequence appreciably reduced by comparison with the high level it had reached in the autumn of 1951, and it has scarcely varied in the course of the last few years.

### Concluding Remarks

The object of the account which I have just given of certain difficult periods in the economic history of my country has been, as I said at the beginning of this lecture, to place before you some examples of disturbances of monetary equilibrium and economic balance in which credit policy has played a decisive part in inducing movements of important dimensions towards the expansion or contraction of economic activity.

Each of the periods dealt with really deserved — and deserves — a more thorough and detailed examination than I have been able to undertake in this lecture.

A review of the monetary events in a country comes close to being an outline of the course of its economic history. For the stability of, or the fluctuations in the purchasing power of its currency do, in the last analysis, summarise the events — happy or unhappy, favourable or adverse — of its economic development.

Thus, in the very turbulent years of the first period of monetary difficulties to which I have referred, which occurred towards the end of the last century, not long after the unification of my country, the economic progress which was being made was not easy to discern; and in any case the rate of progress was slowed down by the destruction of capital and the acute recession caused by the mistaken credit policy.

These years were followed for Italy by a prosperous period of economic development extending over the first fifteen years of the present century, during which the conduct of the country's monetary affairs was exemplary. A factor aiding the stability and economic progress of this period was the well-balanced activity of a group of newly-formed and well-organised commercial banks, which were engaged in healthy but not excessive competition with each other and which were continually expanding in a manner which was neither too violent nor too spasmodic.

The central banks which had survived the economic storm which ended in 1893 with the liquidation of one of their number and the merging of three others to form the Banca d'Italia took determined action during these years to mitigate abnormal movements of credit; they gradually transformed the frozen assets inherited from the past into liquid resources, and converted a substantial proportion of these into foreign currency holdings deriving in large part from the rapid growth in emigration. During this period the ebb and flow of these reserves of foreign currency safeguarded the monetary equilibrium of the country.

The difficulties which characterised the period between the two world wars were, on the other hand, particularly unfortunate. In addition to the factors productive of instability and crisis which had their origins elsewhere and which naturally spread to my country, other factors were at work which were peculiar to the Italian economy itself and which on several occasions brought about serious disturbances in the economic and financial system.

In some of these instances the credit system itself was responsible for serious deviations from the line of conduct which it ought to have followed in order to help maintain, or restore, economic stability. In particular, a very harmful influence was exerted by the excessively rapid expansion of certain banks and the unrestrained competition between them.

The situation was sometimes aggravated by the obligation imposed on the central banks to create large amounts of money for purposes other than the maintenance of a healthy and steady development of production, and by the excessive use of short-term Treasury bills to cover budget deficits. And in other cases it was regrettable that the powers of the central bank — which was at last reduced to a single institution in 1926 — did not include the authority to take measures, such as the imposition of minimum reserve requirements on the banks, which are particularly suitable for correcting — if necessary gradually — the dangerously unbalanced liquidity situations which are sometimes produced by exceptional events.

This authority was, on the other hand, as I have mentioned, exercised to the full, and with great success, in order to put a stop to the inflation of 1946-47.

Since that time the national income of my country has been increasing substantially year by year. A far-reaching transformation is in progress in Italy, under the impulse given by the development of the southern part of the country and by the increasing share of our manufacturing industries in world trade, which we partly owe to the almost complete liberalisation of trade with the vast area represented by the European Payments Union. Both these factors have made possible a fuller utilisation of existing industrial plant and considerable increases in productivity.

Not since before the first world war has Italy known such a prolonged period of marked and continuous economic development as that which she has been experiencing these last eight years or more. This development has been accompanied, moreover, by a high degree of monetary stability and by the accumulation of ample foreign exchange reserves which have made it possible to correct temporary disequilibria in the balance of payments.

In the field of public finance, this period has been characterised by the renewed effectiveness of fiscal instruments, which had been



almost destroyed or rendered inoperative by the war and by inflation. This new efficacy of the instrument of taxation has made it possible gradually to cover an increasing part of the government's expenditure by tax revenue, so that the budget deficit has been progressively reduced and is still falling. The consequence has been a considerable slackening of the tendency towards excess liquidity which usually results from budget deficits and afterwards has to be mopped up by monetary policy.

Among the many causes which have helped to bring about these favourable and encouraging events, on which my country is basing its hopes of an ever-growing development of productive investment and of increasing well-being for its population, I must mention the by no means unimportant rôle played by credit policy. Though far-reaching and penetrating, bank lending has not overstepped the limits beyond which it would have encouraged speculative movements characteristic of inflationary processes and would have created balance-of-payments deficits larger than could be covered by available foreign investment capital, including foreign loans.

May I be allowed to say once more how much the close ties which were established between the central bank and the commercial banks in the autumn of 1947 have contributed to this very harmonious development of credit policy, which has stimulated and accompanied the increase in the national income over these years. This system of inter-bank co-operation has been fostered in a number of ways, so as to make possible the prompt correction of temporary disequilibria affecting the liquidity of the market.

This is really the gist of what may be learnt from Italy's experience in the period since the second world war. While making use of the ever more highly developed means of action adopted elsewhere, Italy has also benefited and drawn strength from the lessons, sometimes painful, which she has learnt from her own past.

Adequate use has been made of the appropriate instruments of monetary policy whenever there have been very marked disequilibria to be corrected; when, on the other hand, the disequilibria have been minor and temporary in character, an important contribution to the redressing of the position has been made by the cordial relations existing between the central bank and the commercial banks, and by the constant contact maintained between their leading officials. These contacts have made it possible to reconcile each commercial bank's own requirements with the need for the banks, both as individual concerns and as a group, to bring their policy into line with that of the government in its efforts to promote the growth of production on a basis of monetary equilibrium.

If, in conclusion, my insistence on the need for reciprocal esteem and constant co-operation between the central bank and the commercial banks should seem to you — like the use of the instruments of monetary policy — to be merely a « rediscovery » of the rules of good conduct which were always considered essential for success, my lecture will have had the not unusual fate of ending where it began. And it will seem utterly pointless to those who expect to find the rules of sound credit management in handbook form. The sound conduct of credit policy merely consists in the tackling of innumerable difficulties which can be overcome only by patient daily effort, sometimes in the face of considerable obstacles, which differ from country to country. The results are consequently nearly always fairly far removed from the original goals.

In drawing up the rules of sound credit management one must not overlook the question of how and when they are to be applied by those in charge of monetary policy. The principles of economic theory must, therefore, at all times be « married » with the art of the banker.

Our scientific knowledge teaches us that dear money and restricted credit are necessary to stop inflation or check a boom, and that cheap and plentiful money must be called

into play as part of the effort to combat a recession. But the art of the banker consists in judging when is the most suitable time for taking action and how far it should go; for the best results are obtained when measures are adopted before the need for action has become clearly apparent in the statistics. And

in countries which possess well-organised monetary systems action is guided by a very sensitive alarm mechanism, which gives a warning whenever a change in the state of business is imminent.

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