PRINCETON STUDIES IN INTERNATIONAL FINANCE, NO. 1

Monetary and Foreign Exchange Policy in Italy

Friedrich A. and Vera C. Lutz

PUBLISHED FOR INTERNATIONAL FINANCE SECTION
BY PRINCETON UNIVERSITY PRESS · 1950

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DEPARTMENT OF ECONOMICS AND SOCIAL INSTITUTIONS

PRINCETON UNIVERSITY

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(DEPARTMENT OF ECONOMICS AND SOCIAL INSTITUTIONS)
BY PRINCETON UNIVERSITY PRESS, PRINCETON, NEW JERSEY
1950

London: Geoffrey Cumberlege, Oxford University Press

Printed in the United States of America by Princeton University Press
at Princeton, New Jersey

PRINCETON STUDIES IN INTERNATIONAL FINANCE

WITH this study by Professor Friedrich A. and Vera C. Lutz the International Finance Section of the Department of Economics and Social Institutions in Princeton University inaugurates a new series, called PRINCETON STUDIES IN INTERNATIONAL FINANCE. Additional numbers will be published from time to time. Contributions will not be limited to those from persons associated with Princeton University.

It is intended that the present series will be restricted to meritorious research studies in the general field of international financial problems, both policy and theory, which are too long for the journals and too short to warrant publication as books.

The International Finance Section will continue to publish from time to time papers in the ESSAYS IN INTERNATIONAL FINANCE series which was begun in 1943 under the direction of the late Professor Frank D. Graham. As in the past, these publications will be confined in length, content, and style to scholarly papers which may properly be called essays.

The practice will be continued of distributing the Essays free of charge to persons seriously interested in international financial questions. Because of high printing costs, however, the PRINCETON STUDIES IN INTERNATIONAL FINANCE will be sold at prices calculated to cover partially the out-of-pocket costs involved in their publication.

While the Section sponsors both the Essays and Studies, the writers are free to develop their topics as they will. Their ideas may or may not be shared by the editorial committee of the Section or the members of the Department.

GARDNER PATTERSON, *Director*
International Finance Section

Princeton University
January 1950

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I. Introduction[1]

At the close of hostilities Italy was to be counted among those countries of Western Europe which had suffered most severely from the consequences of the war. The physical destruction wrought by the passage of war across her territory on her capital equipment, especially on her transport system; the impoverishment of her soil due to years of exceptionally intensive cultivation combined with an inadequate supply of fertilizers; the heavy inflation of the volume of money whose effects on the price structure had been partly repressed; the exhaustion of her foreign exchange reserves; the heavy reduction of her merchant fleet, which caused shipping to become a large debit item in her balance of payments; the relative poverty at all times of her natural resources, and the necessity of importing a good part of her basic foodstuffs (especially wheat) and almost all of her raw materials (cotton, wool, coal, oil, iron); the necessity of finding a new political equilibrium; all these factors confronted her with problems as formidable as those facing almost any country in Western Europe.

In these circumstances the progress which Italy has made towards economic revival, and towards a solution of her problems of economic adaptation, compares very favorably with that of other European countries. In the years 1946-48 the level of her production approximately doubled; for, whereas in 1946 it was probably only about half of the pre-war level, by 1948 it had almost regained that level. Before the end of 1947, the inflation, which had threatened earlier to grow to serious proportions, had

[1] The most detailed analysis of the economic situation in Italy is that given in the annual reports of the Governor of the Bank of Italy. The main sources for the statistical and factual data used in this study are these reports, the bi-monthly statistical bulletin of the Bank of Italy (*Bollettino del Servizio Studi Economici*), and the monthly bulletin of statistics issued by the Central Statistical Office (*Istituto Centrale di Statistica, Bollettino Mensile di Statistica*, appearing as a supplement to the *Gazzetta Ufficiale della Repubblica Italiana*). We have also benefited from contacts with Dr. Paolo Baffi and other members of the Research Division (*Servizio Studi Economici*) of the Bank of Italy, who provided us with supplementary statistical material, aided us in interpreting this material, and helped us acquaint ourselves with the institutional framework within which monetary and foreign exchange policy operates in Italy. Without their help this study could not have been written. The responsibility for the appraisal of the material and for the opinions expressed is, however, entirely our own.

been arrested. By the end of 1948 Italy had achieved a marked improvement in her balance of payments position: she was a creditor of the sterling area and of most European countries, and she had used part of her American aid to replenish her dollar reserves. The one major problem still facing her was the pressure of her large population on her limited resources: this reflects itself first in a very low average income per head of the population (about $200 per annum, or not much more than one-quarter of the figure for the United Kingdom), and secondly, given the policy of the trade unions in fixing wage standards, in heavy unemployment.

In the first section of this study we shall give an account of the internal monetary policy before and after the stabilization of the price level, and shall add some reflections on the unemployment problem. In the second section we shall deal with the balance of payments, and in the third with the foreign exchange policy, a policy of flexible exchange rates, as the result of which a "realistic" lira rate for the dollar was reëstablished, and the lira became, from the point of view of Europe, one of the "hard" currencies.

II. Internal Monetary Developments

We shall here concentrate on the monetary developments which have taken place in Italy since the middle of 1946. This date is chosen because it marks the beginning of a new inflationary process setting in after roughly a year of relative stability. For purposes of the analysis we shall divide the period between the middle of 1946 and the summer of 1949 into four sub-periods:

1. The end of June 1946 to the end of September 1947. During these fifteen months the volume of money expanded rapidly and prices rose sharply.
2. The end of September to the end of December 1947. In September credit restrictions were imposed on the banking system, with the result that credit expansion by the banks was almost stopped, and prices fell.
3. The year 1948. During this year prices remained roughly stable, in spite of a comparatively rapid credit expansion by the banks and in spite of a further increase in the amount of currency in circulation.

4. January to August 1949. In this period wholesale prices showed a falling tendency, credit expansion by the banks occurred at a much reduced rate, and the volume of currency in circulation was approximately stable.

June 1946 to September 1947.

In the middle of 1946 the price level[1] was roughly 26 times, and the volume of currency in circulation (not including check accounts) 20 times as high as in 1938. No reliable index of production exists for this period; but it is estimated that industrial production for the year 1946 was still less than half the level of 1938, and that, if agricultural production was included, the level of total output did not reach 60 per cent of the 1938 level.

For purposes of investigating the change in the money supply that occurred in this period, two series are here considered: (a) Currency in circulation, consisting of notes issued by the Bank of Italy (including the so-called AM-lire, *i.e.* notes issued by or on behalf of the Allied authorities), Treasury currency, and circular checks (*i.e.* checks which circulate from hand to hand) issued by the Bank of Italy and by other credit institutions. (b) The total of currency in circulation *plus* bank money, representing an approximation to the total money supply in the Italian economy.[2] (See Chart and Table I).

In our first period currency in circulation expanded at an average rate of 4.7 per cent per month, and the total money sup-

[1] The price index is a weighted average of legal prices and black market prices. The two sets of prices closed in towards each other after September, 1947; controls were gradually removed, and black market prices declined after that date. Few price controls were still in force in 1948, and after February, 1949, "legal prices" were no longer quoted. Price controls had, however, never been very effective since the end of the war.

[2] The Italian banking statistics do not allow us to separate out accurately from the total of deposits those deposits on which checks are drawn. The statistics distinguish between two types of deposits: business deposits (*conti correnti di corrispondenza con clienti*) and what we shall call savings deposits (*conti correnti fiduciari*), each type being subdivided into demand deposits (*conti correnti liberi*) and time deposits (*conti correnti vincolati*). In the series used in the text business deposits (inclusive of time deposits which, however, constitute only a very small proportion of the whole) have been taken to represent "bank money." The inclusion of time deposits may be justified on the grounds that the error arising from this source is to a certain extent compensated by the presence among the savings deposits of some deposits on which checks are drawn. Postal check accounts are also included in series (b).

PRICES, VOLUME & MONEY AND DOLLAR RATE, IN ITALY. *INDICES: BASE 1938 = 1*

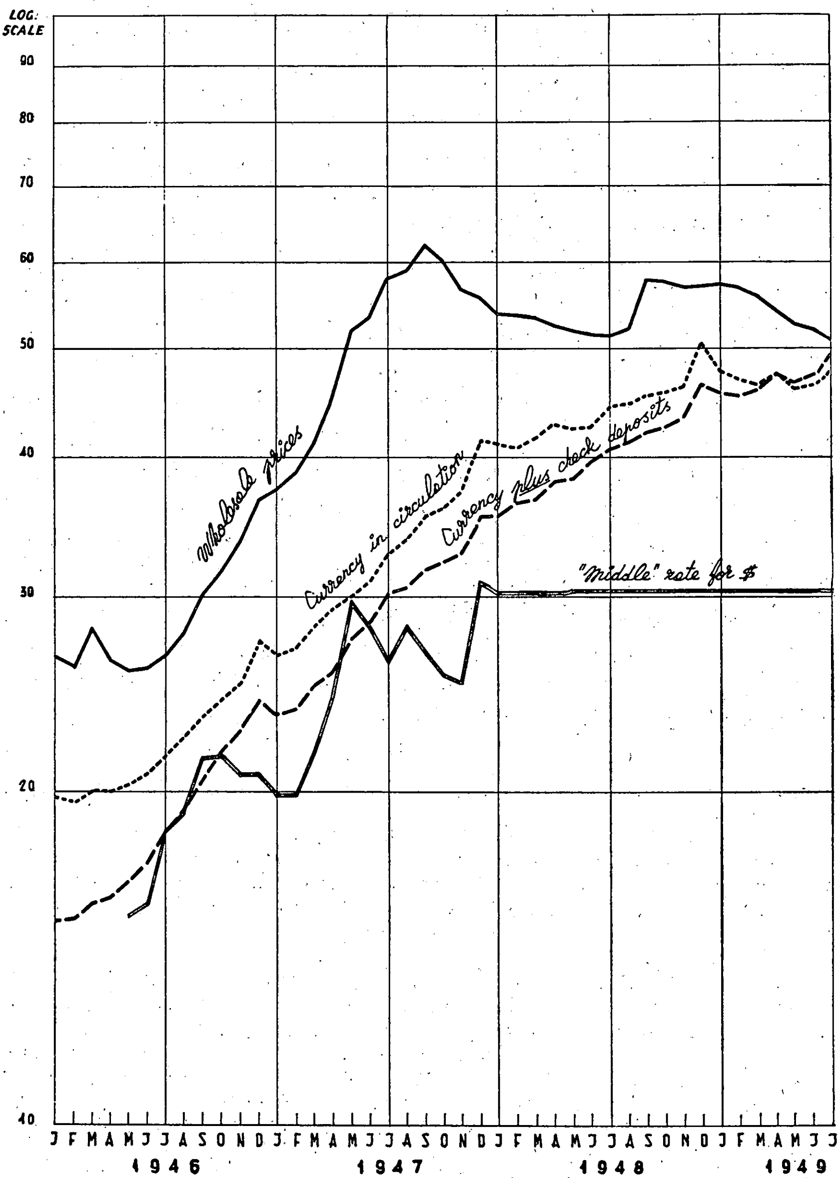

TABLE I

SELECTED ECONOMIC DATA FOR ITALY

Year and month	Currency in circulation[1] (Billions of lire)	Volume of money[1] (Billions of lire)	Wholesale price index	Cost of living index	Wage index	Index of production (1947=100)
1938						
(average)	22	40	100	100	100	
1946						
June	458	695	2,593	2,627	1,654	
September	511	830	3,011	2,810	1,842	
December	600	979 (955)[2]	3,677	3,416	2,758	
1947						
March	619	1,009	4,139	3,823	3,185	90
June	684	1,155	5,329	4,655	4,131	111
September	779	1,284	6,202	5,331	4,670	108
December	909	1,427	5,526	4,929	5,105	98
1948						
March	916	1,482	5,318	4,919	5,133	103
June	933	1,604	5,142	4,835	5,135	109
September	993	1,701	5,769	4,910	5,416	119
December	1,104	1,870	5,696	4,917	5,415	112
1949						
March	1,014	1,854	5,557	4,980	5,424	110
June	1,016	1,916	5,219[3]	4,990	5,426	127
July	1,058[3]	1,984[3]	5,124[3]	4,834	5,426	124

[1] For the items included, see text p. 3. The figures relate to the end of each month.

[2] From December 1947 on the figures are exclusive of foreign exchange accounts (*conti valutari*).

[3] Provisional.

ply at a rate of 5.6 per cent. There were two main reasons for this expansion:

(1) the government's recourse to the Central Bank and to the banking system in order to satisfy its needs for funds, and

(2) the expansion of bank loans to private business.

As Table II shows, the government's recourse to the Central Bank was the most important single factor making for the increase in the note issue. The "wheat bills" (shown separately in the table) must also be counted as an obligation of the government, and should, therefore, be added to the credit given to the latter by the Central Bank. They represent rediscounts of bills issued to finance the collection of crops, principally wheat. The wheat was sold by the farmers to the mills at a price which covered

TABLE II

BANK OF ITALY: FACTORS MAKING FOR AN INCREASE (+) OR DECREASE (—) IN NOTE CIRCULATION[1]

(Billions of lire)

	June 1946 to Sept. 1947	*Sept. 1947 to Dec. 1947*	*Dec. 1947 to Dec. 1948*	*Dec. 1948 to Aug. 1949*
Credit to government	+66.3	+100.3	+159.1	
"Wheat bills"	+64.7	+30.3	+.2	+16.6
Private credit	+38.7	+19.9	+5.3	
Foreign exchange and gold[2]	+19.4	+31.6	+169.8	+199.5
Deposits[3]	+95.0	—54.6	—97.0	—123.3
Counterpart funds[3]	—	—	—58.2	—105.0
Balance of remaining items	—11.0	—7.1	—8.3	—8.3
Increase or decrease in note circulation	+273.1	+120.4	+170.9	—20.5

Notes in circulation at end of June 1946 = 394.7
Notes in circulation at end of August 1949 = 942.5

[1] Calculations based on end-of-month figures.

[2] These figures are only approximate since foreign exchange is included under the head *debitori diversi* which also includes certain other minor items.

[3] An increase in deposits or in counterpart funds, making for a decrease in the note issue, has a *minus* sign in the table, and a decrease a *plus* sign.

only the cost of handling and transportation, and the entire amount paid to the farmers in excess of these costs represented a charge on the government, which had to find the funds when the bills fell due. If the "wheat bills" are included, the credit given to the government amounts to 48 per cent of the increase in the note issue.

The government also borrowed from the private banking system (see Table III), though on a much smaller scale.[1] It thus contributed to the withdrawal of currency by the public from the banking system (the second most important item responsible for the increase in currency in circulation), and to the increase in bank money.

[1] In the Italian literature on the subject it is customary to deduct from the public credit given by the Central Bank an item corresponding to the banks' deposits with the latter, on the grounds that these deposits are invested by the Central Bank in Treasury Bills and are thus indirectly lent by the private banks to the government, which pays the difference between the interest rate on the deposits and the rate on Treasury Bills. The credit given by the private banks to the government is raised by a corresponding amount. We do not follow this custom here. If we did so, consistency would require us to say that the credits granted by the banks are "in reality" granted by their depositors: indeed the whole banking system would have to be eliminated if this procedure were consistently applied.

TABLE III

PRIVATE CREDIT INSTITUTIONS
(Billions of lire)

	Credit to government	*Credit to private business and local authorities*	*Check deposits*	*Savings deposits*	*Total deposits*
End of—					
June 1946	182.5	226.2	219.9[1]	312.3	532.2[1]
Sept. 1947	234.0	706.9	471.1	474.9	946.0
Dec. 1947	250.5	723.2 (783.3)[2]	485.4	528.5	953.9
Dec. 1948	414.2	1,120.7	714.8	805.5	1,520.3
June 1949	446.2	1,234.7	811.4	860.9	1,672.3
Aug. 1949	(a)	(a)	835.4	932.0	1,767.4

[1] For this month figures include *conti valutari.*

[2] New series (from December 1947 on) based on improved method of excluding the *conti valutari.*

(a) Not available.

The budget deficits which gave rise to such heavy borrowing by the government are shown in Table IV. The Italian government publishes two accounts, the regular budget, corresponding to the budget statements of other countries, and a budget on a cash basis showing the *actual* receipts and expenditures during the accounting period, including the receipts from new borrowing and the

TABLE IV

BUDGET DEFICITS OF THE ITALIAN GOVERNMENT[1]
(Billions of lire)

1946-47	569
1947-48	787
1948-49[2]	440[3]
1949-50[2]	174[4]

[1] The financial year runs from July 1st to June 30th. The deficits shown in the table are those of the regular budget.

[2] Figures given by the Italian Minister of the Treasury in a speech before the Chamber on July 5th, 1949.

[3] Deficit of 510 less 70 taken from the lira fund ERP (counterpart funds) for financing railway reconstruction.

[4] Net of investments estimated to amount to 121 which it is proposed to cover out of the lira fund ERP. It should be observed also that the 1949-50 deficit is so low partly because it excludes expenditures of 113 on public works, which, as the result of the introduction of a new system of accounting, are to be charged to the budgets of future years as and when the bills used to finance those expenditures fall due.

outlays for debt redemption. The difference between all receipts and outlays in any period equals the change in the Treasury's cash balance held with the Bank of Italy. It must, however, be pointed out that this "cash balance" may be a negative item indicating that the government owes a corresponding amount to the Bank of Italy.[1]

As actual payment of some of the expenditures incurred in the current fiscal year may be postponed, and the amount of such unpaid expenditures may exceed the amount of receipts which have accrued during the year but have not yet been collected, an excess of payments due from previous fiscal years over receipts still to be collected on account of previous years may accumulate, and this excess (which forms the larger part of the so-called "residui") may burden future years with heavy outlays which will not be found in the ordinary budget of those years but will, of course, enter the cash budget. The total "residui" were estimated in the middle of 1948 at no less than Lit. 770 billions. Part of them consist, however, simply of appropriations made in previous years but not used in those years; exactly how large a part constitutes the excess of actual expenditures not yet paid over receipts accrued but not yet collected (and therefore an additional form of credit to the government) cannot be estimated.[2] It is believed that the "residui" have reached their maximum and will gradually decline in the future.

We cannot here enter into a detailed analysis of the Italian budget. It must suffice to say that, on the revenue side, indirect taxes provide the largest part of the current revenue, with income from state monopolies (tobacco) next in importance, and the yield from the income tax taking only third place. The heaviest single item shown on the expenditures side has in the last few years been expenditures for investment purposes, although no very exact figure of the total investment expenditures can be given because some of them are included under various budget items which also cover expenditures of a non-capital type. A large part of the

[1] The relevant item in the statement of the Bank of Italy is labelled *conto corrente del Tesoro per il servizio di Tesoreria*, an item which can appear either on the assets or on the liabilities side of the statement.

[2] Large items among this part of the "residui" are the "wheat bills," and reparations fixed in the Peace Treaty but not yet paid.

investment expenditures were undoubtedly an absolute necessity in the first post-war years (as, for example, those on reconstruction and repair of railways, bridges, roads and the telephone system), because the revival of the whole Italian economy depended on them. The cash outlays for investment purposes during the fifteen months under consideration (estimated at roughly Lit. 260 billions) amounted to 87 per cent of the increase in the public debt of Lit. 299 billions (an increase which includes the increase in the government's "negative cash balance"). Part of this increase in the public debt took the form of a Reconstruction Loan which brought in Lit. 231 billions. If all the investment outlays could have been financed by loans placed with the public, no inflationary effects would, of course, have resulted from this increase in the public debt. As it was, however, Lit. 118 billions, or 45 per cent of the total, had to be obtained from the Bank of Italy and the private banks,[1] the remainder being placed with the public, the postal savings banks, insurance companies, etc.

The inflation itself constantly widened the gap between government receipts and expenditures, and caused the budget deficit to be much larger than originally forecast.[2]

The second important factor contributing to the increase in the volume of money was lending by the banks to private business (see Table III). The rising demand for funds on the part of business had several causes. First, production was rapidly expanding; the index of production compiled by the Central Institute of Statistics (available only from January 1947 on) showed an increase of 42 per cent between January and September 1947.[3] Secondly, the rise in prices and costs increased the demand for funds. The importance of this factor may be gauged from the fact that wholesale prices at the end of the period were 139 per cent, and wages

[1] See Tables II and III. The figures in the text exclude the wheat bills which do not appear as part of the government debt.

[2] The original estimates and the actual results for expenditures and revenues in the financial year 1946-47 were as follows:

	Estimates	*Actual Results*
	(Billions of lire)	
Expenditures	341	921
Revenues	148	352
Deficit	—193	—569

[3] Industrial production shows a seasonal low at the beginning of the year.

even 182 per cent above the level of the beginning of the period. From the end of 1945 on the wages of organized labor had been tied to the cost of living index, and they were also raised by an additional 35 per cent in October 1946.[1] Finally, traders and manufacturers accumulated large inventories (especially of raw materials) as an inflation hedge, and financed them primarily with bank credit.

The banks were able to satisfy the heavy demand for loans because they had entered the period with a very high liquidity ratio. At the end of June 1946 the reserve ratio of those banks which later became subject to the new reserve requirements was 43 per cent; by September 1947, just before the new reserve requirements came into force, the ratio was down to 22 per cent.[2] This fall was caused partly by the expansion of deposits, but partly also by a decline in the absolute amount of reserves. This latter fact seems at first sight surprising considering that the Central Bank, all during the fifteen months, was issuing notes on behalf of the government, and we might have expected these notes to be deposited with the banking system thus swelling its reserves. No such increase in reserves took place, however. The explanation lies in the change in the ratio of deposits to notes. If we suppose that deposits expand at the same rate as the notes issued by the Central Bank on behalf of the government, and that the initial ratio between deposits and notes in circulation is preserved, the notes issued by the Central Bank will necessarily remain in circulation, the banks' reserves will not increase, and the expansion of deposits by the banking system will take place at the expense of a drawing down of its reserve ratio. Under these strict assumptions, the absolute reserves will remain constant. A *decline* in the absolute reserves implies a reduction in the ratio of total deposits (check

1 The sliding wage scale, adopted at the end of 1945 and revised in October 1946, provides for adjustments of wages two months after a change in the cost of living index is registered. Downward adjustments take place, however, only when the fall in the cost of living index exceeds 8 per cent. Adjustments are made only in one part of the wage, *i.e.* in the "cost of living allowance" but not in the basic wage. Since the "cost of living allowance" is the same for all classes of workers, the effect of the inflation was to lead to a narrowing of wage differentials as between skilled and unskilled workers and as between male and female workers.

2 The ratio is calculated using the banks' deposits with the Bank of Italy and/or the Treasury *plus* their cash on hand as the numerator, and their total deposits as the denominator.

plus savings deposits) to notes in circulation, and this is what actually occurred during the period under consideration. The decline in reserves meant, of course, that bank loans expanded faster than deposits.

The fifteen months showed all the typical signs of an inflation: a flight into "real values" (especially inventories), a rise in share prices,[1] a fall in bond prices (*i.e.* a rise in their yield which, however, was insufficient to compensate for the fall in the value of money). Two other typical phenomena deserve special mention: First, the increase in savings deposits lagged behind the increase in the amount of currency in circulation, and also behind the increase in check deposits, thus reflecting a decline in the propensity to save. At the end of June 1946 the ratio of savings deposits (including postal savings deposits) to currency in circulation was 93 per cent, and in September 1947 it was only 83 per cent, whereas the ratio of check deposits to currency in circulation had risen (from 52 to 64 per cent). Secondly, the velocity of circulation of money increased sharply; in other words, business undertakings and the general public reduced the ratio between their cash balances and their expenditures. The total volume of money (including check deposits) increased during the period at a monthly rate of 5.6 per cent while the price level rose at a rate of 9.3 per cent. As production also increased, part of the addition to the volume of money was compensated by the increase in the supply of goods, and the velocity of circulation must, therefore, have risen even more than the mere contrast between the rate of increase in the price level and the rate of increase in the money supply would suggest. As we shall see, the decline in the velocity of circulation played an important role in the stabilization period.

September to December 1947

These are the crucial months in which the inflationary process was brought to a standstill. The authorities, intent on stopping inflation, could attack on three points. The first was the budget. But the balancing of a budget which is in serious disequilibrium

[1] Share prices began to fall as early as May 1947 when speculators started liquidating their positions in the expectation that the inflation was not going to continue much longer. This expectation was reinforced by the announcement of the financial program of the new De Gasperi Government early in June.

can rarely be achieved in a short period. In fact the deficit for the financial year 1947-48 was larger than that of the previous financial year. The second possibility was to stop the credit expansion by the private banking system, and the third was to bring down the velocity of circulation of money. But the velocity could be reduced only if the public could be convinced that further price rises were not to be expected; that is to say, the authorities could hope to reduce the velocity only if they first succeeded in stopping the price rise by adopting either the first or the second procedure. Since the budget deficit could not be eliminated immediately, only the second procedure, the stopping of further credit expansion by the private banks, was practically at the disposal of the authorities. By placing credit restrictions on the banking system they did indeed achieve, first a temporary cessation of further credit expansion, and *through this* a decline in the velocity of circulation of money. We thus witness in Italy a unique example of an inflationary process which was broken by operating on private bank credit, while at the same time the budget deficit was still increasing and the Central Bank had to satisfy the government's needs for funds through the printing press. Professor Einaudi, at that time Governor of the Bank of Italy and Minister of the Budget, was instrumental in carrying out these restrictive policies.

The new reserve requirements imposed on the banks as from the end of September 1947, were as follows:

(1) Deposits held by the banks in excess of ten times the net capital must, to the extent of 20 per cent, be invested in government securities or government-guaranteed securities to be deposited with the Bank of Italy, or must be paid into a special deposit account held at the Bank of Italy or the Treasury. The sums thus tied were, however, in no case to exceed 15 per cent of total deposits.

(2) From October 1st on, any increment in deposits was to be invested or deposited, to the extent of 40 per cent. But the whole percentage of deposits to be invested or deposited was not to exceed 25 per cent. Deposits are considered net of foreign exchange accounts (*conti valutari*) and of interbank deposits.[1]

1 One aspect of these reserve requirements deserves comment from the point of view of banking theory. As the reserves can be held either in the form of deposits

These reserve requirements would not have slowed down the credit expansion by the banking system if the banks could have relied on obtaining additional reserves from the Central Bank. The banks had, however, been expressly warned, in August, that they could not count on borrowing from the Bank of Italy except in special circumstances. And early in September the rediscount rate had been raised from 4 to 5.5 per cent.

The new policy was intended not to produce a *contraction* of bank lending, but only to prevent a further expansion. In this it succeeded. The ratio of free cash reserves to deposits was, as a result of the restrictions, cut down from 22 to 7.7 per cent. Bank loans to others than the government showed, during the next three months, a monthly rate of expansion averaging only .7 per cent as against 14.2 per cent in the previous fifteen months, and check deposits of the banks displayed a rate of increase of 1 per cent.

The slowing down of the credit expansion exerted a downward pressure on prices. The events of these three months illustrate the conclusion reached in the theory of inflationary processes that it is not possible to stop a credit expansion, or even to slow down the rate of expansion, without provoking a price recession. The fact that additional credit was no longer obtainable meant first of all that further accumulation of inventories by traders was stopped. This alone, by diverting to the consumers' market the part of the current output which had previously been added to

with the Central Bank (or the Treasury) or in the form of government securities, it looks as though the banking system could create its own reserves simply by purchasing government securities. Such action would set free part of the deposits formerly held as reserves with the central monetary authorities, and although the new deposits created by the purchase of the government securities would be partly withdrawn in cash (to the extent of roughly one-half in Italy where the ratio of check deposits to notes in circulation is at present approximately one), the banking system would still be left with some free cash on which further deposits could be built through loan expansion. Such a process could be started unwittingly by any individual bank, provided the bank had some inducement to shift from deposit reserves to security reserves, *e.g.* if government securities offered a higher yield than the interest earned on deposit reserves. It is necessary, therefore, if a multiple expansion process is not to be started in this way, that the return on both kinds of reserves should be approximately equal. This is indeed the case in Italy where the rate on deposit reserves is the same as the rate on Treasury Bills. (The rate on Treasury Bills is actually .25 per cent below the rate on deposit reserves; but when allowance is made for income tax which has to be paid on the interest received on deposits but not on the yield from Treasury Bills, the effective rates are the same.)

inventories, would have increased the current supply of goods sold in the market and would thus have exercised a downward pressure on prices, even if no sales from already existing inventories had taken place. But, in addition, the traders, in response to the first signs of a fall in prices and the expectation that they would fall still further, sold part of their existing inventories, and the price fall was thus accentuated. We should expect the money proceeds of such sales to be used to repay bank loans. The banking statistics, however, show no net decline in loans. It appears that while traders reduced their inventories, manufacturers, though reducing their inventories of raw materials by buying less from abroad, increased their inventories of final products, because of internal rigidities due especially to the difficulty of dismissing workers. Also, since the adjustment of wages to the cost of living index works with a lag (the changes are calculated every two months), wage bills went on increasing, in response to the price rise of August and September, after prices had begun to fall. This fact, as well as the accumulation of inventories of final products, increased manufacturers' needs for funds, and in consequence no net decline in bank loans took place.

The price level actually fell at an average rate of 3.6 per cent per month in the last quarter of 1947. The fall occurred in spite of a simultaneous increase in the note issue caused mainly by further borrowing from the Central Bank by the government (see Table II). Indeed the average monthly expansion in the volume of notes in circulation was higher in the last quarter of 1947 than in the previous fifteen months, and the total money supply continued to increase at the monthly rate of 3.7 per cent. Industrial production fell, on the other hand. It must, therefore, be concluded that the velocity of circulation of money declined sharply; in other words, the cash balances of the public acted as a reservoir into which the additional money flowed. This reconstitution of cash reserves more than compensated for the increase in the money supply, so that prices fell in spite of the monetary expansion.

The year 1948

This was again a period in which forces were working strongly in the direction of renewed monetary expansion. The government's needs for funds, the increasing demand for bank loans, and a new factor (hitherto of relatively small importance), the acquisition of foreign exchange, all tended to increase the money supply in the Italian economy (see Tables II and III). The wholesale price level, however, remained roughly stable; the rise which the index registered in August was due to the removal of food subsidies.

The public debt increased by Lit. 421 billions, or if we include the Treasury's negative cash balance, by Lit. 498 billions. This compares with an investment outlay by the government of roughly Lit. 375 billions. The total amount which the government borrowed from the banking system (including the Bank of Italy) was Lit. 323 billions, or 65 per cent of the total, but a much larger part than previously was taken from the private banks. The government borrowed approximately half from the Central Bank and half from the private banks. But since at the same time the bulk of the ERP counterpart funds were allowed to accumulate in the Central Bank, thus creating a credit item for the government with the Bank (amounting by the end of 1948 to Lit. 58 billions), we are entitled to deduct a corresponding amount from the Bank's credit to the government. The result then is that out of a total credit given by the banking system to the government of Lit. 265 billions only 38 per cent came from the Central Bank.

Two factors thus helped to minimize the inflationary effects of the budget deficit and of the acquisition of foreign exchange. The first was the accumulation of the counterpart funds. The second was the fact that the banks became heavy buyers of Treasury Bills (partly owing to the necessity of complying with the reserve requirements), and this enabled the government to reduce its borrowing from the Central Bank, and thus to avoid the creation of additional notes which would most likely have swollen the reserves of the private banking system thus allowing a higher rate of loan expansion.

The loans granted by the private banking system to the government and to private borrowers expanded during the year at an average monthly rate of 4 per cent, the increase being more rapid in the second half of the year than in the first, owing to the harvesting of the crops and an accelerated rate of industrial expansion during the last six months. Total deposits of the banks increased at a more rapid rate (5 per cent), the difference between the increase in deposits and the increase in loans being added to their reserves. The increase in bank loans to business occurred in spite of the very high rate of interest on bank accommodation, a rate which, together with the fees charged to the borrower, amounted to more than 10 per cent.[1] The banks, which had to set aside increased reserves, in accordance with the new reserve requirements, were able to support the rising level of deposits thanks mainly to three factors:

(1) The ratio of currency in circulation to deposits fell during the year.
(2) There are indications that the banks changed the composition of their reserves in favor of more government securities, thus releasing deposit reserves.[2]
(3) The banks let the ratio of their free reserves to deposits fall from 13.1 to 7.5 per cent during the year.

The volume of money (currency in circulation *plus* check deposits) increased during the year by 31 per cent. This is far more than the increase in industrial production which rose by 11 per cent. Since the price level remained stable, it is evident that the reconstitution of cash balances by the public must have continued, thus absorbing part of the newly created money. The process of building up cash reserves in the form of currency and bank deposits (a process which began in the last quarter of 1947 and continued during 1948) was of paramount importance, inasmuch as it permitted a non-inflationary credit expansion by the banks, and gave the government a breathing-space in which it could gradually eliminate the budget deficit, or at least reduce it to proportions which could be financed out of the savings of the public. If, however, it is correct, as many Italian observers assert, that cash balances were almost back to normal by the end of 1948, it follows that monetary expansion could not be allowed to proceed at the same pace in 1949 as in 1948.

1 In 1948 the yield on perpetual bonds averaged 5.3 per cent, and the rate on 10-12 month Treasury Bills 5.0 per cent.
2 Cf. footnote on p. 12.

January to August 1949

Indeed, monetary expansion slowed down considerably in the first eight months of 1949.

Notes in circulation were at the end of August Lit. 20.5 billions below the level of December 1948. Although the further acquisition of foreign exchange tended to increase the note issue, other factors, in particular the accumulation of the counterpart funds to the level of Lit. 163.2 billions by the end of August 1949, and the increase in the banks' deposits with the Central Bank, more than offset the influence of the growth of foreign exchange holdings (see Table II). The figures for bank deposits which are available up till August 1949 (Table III), indicate that credit expansion by the private banking system slowed down considerably. The main items[1] included in the total volume of money increased in the first eight months at an average monthly rate of .7 per cent as against 2.5 per cent in the corresponding period of 1948.

In broad outline we can describe the various phases of monetary development since mid-1946 in these terms: first, a period of fifteen months of rapid inflation accompanied by an increase in the velocity of circulation of money, followed by three months of falling prices brought about by credit restrictions, and accentuated by a decline in the velocity of circulation; then twelve months of rather rapid credit expansion by the banks which, however, did not have inflationary effects because the additional money did not exceed what was absorbed by the increase in production and the reconstitution of the public's cash holdings; and, finally, the first eight months of 1949 in which, cash balances having been reconstituted, credit expansion was slowed down.

The Unemployment Problem

The Italian authorities have been criticized for following a credit policy which the critics maintain is not sufficiently liberal in view of the persistence of heavy unemployment, which ever since the war has been somewhere between 1.5 and 2 millions against a population (at the end of 1948) of 45.9 millions. In considering this criticism we must first of all bear in mind that

[1] *i.e.* notes in circulation *plus* check deposits: the August figures for the other items were not available at the time of going to press.

Italy's unemployment problem is not simply a "cyclical" phenomenon reflecting the failure to combine unused capacity and surplus raw materials with unemployed workers. It is of a more permanent, structural nature due to the pressure of a large population on relatively meager resources, and the fact that organized labor insists on a standard of real wages which is higher than that at which all labor can be employed. This problem is not new for Italy. Between the wars it was partly solved by emigration. During the 'twenties when the figure for unemployment was relatively low (varying between a minimum of 72,000 and a maximum of 607,000), the figure for annual net emigration of workers averaged about 120,000.[1] The number of unemployed was much higher in the 'thirties (at the seasonal peak of each year it usually passed the million mark, and was usually well over half a million at the seasonal low); during this period the average figure for annual net emigration of workers was only 23,000.[2] Even during the years 1936-41 the average annual unemployment figure was between 516,000 (1941) and 722,000 (1937), and during that period probably about half a million Italians were in the army.

In the post-war period the outlets for emigration are unlikely to be wider than they were before the war, and Italy is faced with an annual population growth for some years to come of about 500,000, involving an annual addition to the working population of 250,000-300,000. The unemployment problem is perhaps further aggravated by two factors: the reluctance of employers to take on new workers because of the difficulty of dismissing them once they have been employed,[3] and the rent control system which decreases the willingness of workers to move from one district to another because, whereas the controlled rents on old houses or apartments are only four times what they were in 1938, the rents on new houses or apartments are about a hundred times the 1938 level.

In the main Italy must evidently look for the solution of her unemployment problem internally, by increasing the ratio of her capital equipment to her population. This inevitably involves an investment program of considerable magnitude, and the question

1 1921-30 average. 2 1931-40 average.

3 In 1945 dismissals were forbidden by law. The law has now been abrogated, but trade union pressure continues to make dismissals difficult.

that remains is how such a program is to be financed. Some of the critics of the present policy argue that it should be done by internal credit expansion even if this were to mean inflation. Against this thesis there are strong counter-arguments. First, the amount of "forced saving" that can be extracted from the public by a given degree of inflation is limited (particularly in Italy where wages are tied to the cost of living index), and the amount becomes progressively smaller the further inflation proceeds. Secondly, the inflation itself causes a large part of the investment to assume forms which cannot be permanently maintained. Thirdly, particularly in a country which has been made inflation-conscious by past experience, inflation destroys the will to save voluntarily, and in the long run the losses of voluntary savings will exceed the gains from forced savings. Through the stabilization policy initiated by Professor Einaudi and continued by his successor at the bank of Italy, Dr. Menichella, the confidence of the public in the lira has been so far restored that the saving habit is beginning to revive, and it is essential that this willingness to save should not be again destroyed. Since, however, given the low level of incomes in Italy, domestic savings cannot be expected to be high in the very near future, we are forced back to the conclusion that any considerable investment program must at present rely either on donations or on loans from abroad. In other words, the volume of foreign aid, or of foreign investment in Italy, will be the principal factor determining the extent to which she can engage on a program of internal credit expansion without endangering the stability of the lira. It is inevitable that a considerable time should elapse before the investment projects (such as irrigation and land reclamation schemes) add to the supply of goods coming on to the market for sale at home or abroad. In the meantime those who are newly employed will exercise a demand for consumers' goods, and there will also be an increased demand for equipment and raw materials. Additional imports financed by foreign loans or donations are required to offset this new demand if the price level is to remain approximately stable. Without foreign aid the Italian authorities, rightly determined to maintain the stability of the lira, cannot do very much to solve the unemployment problem.

It has been contended that they could have done a little more than they actually did in the first part of 1949. Several factors appear to lend support to this view: (1) The wholesale price level actually fell by roughly 10 per cent between December and July. (2) A more liberal credit policy, by keeping up the prices of Italian exports, might have reduced the volume of lending abroad (see Sections III and IV), and thus have diverted a corresponding amount of investment from foreign into domestic channels; in other words, it might have caused a corresponding amount of Marshall aid to be used at home instead of being in effect passed on to other European countries, and particularly to the sterling area. (3) The Bank of Italy had a strong position in the money market. By changing the reserve requirements, by shifting government borrowing from the private banks to the Central Bank or *vice versa*,[1] and by spending more or less of the counterpart funds, the authorities were in a position to influence the money market in either direction.[2] A slightly more liberal credit policy would under these conditions present no very great danger, since, immediately inflationary effects showed signs of appearing, they could be checked.

On the other hand, against the view that the Italian authorities have been over-cautious, it must be pointed out that:

(1) Up to July the price fall was not reflected in the cost of living index, partly because it was compensated by increases during that period in railway fares, public utility rates, postal rates, and rents, which perceptibly affected only the cost of living and not the wholesale price index. And since wages are over a large part of the Italian economy tied to the cost of living index, there was, so long as the latter did not fall, probably very little margin within which the authorities could have operated without soon reaching the point where wages began to rise. Moreover, since there are still some controlled prices, especially rents, which will sooner or later have to be brought up to a level conforming to the new general level of prices, a fall in wholesale prices is necessary

[1] This would require the lowering or raising of the interest rate on Treasury Bills so as to give the banks an incentive to shift between Treasury Bills and loans.

[2] Rediscount policy, in view of the reluctance of the large banks to rediscount, is in Italy a weaker weapon for the Central Bank than it is in many other countries.

in order to allow a margin within which the increase in rents can take place without leading to a rise in the cost of living index, and therefore to a general increase in wages.

(2) The decline in the wholesale price index was so far due mainly to a fall in the prices of agricultural commodities towards a more "normal" relationship to the prices of manufactured goods, and thus simply reflected a tendency noticeable in the world market.

(3) The price fall did not, up to July at least,[1] lead to any decline in economic activity. On the contrary, industrial production went on rising over that period, partly owing to the increased efficiency brought about by a process of reorganization which has been taking place in Italian industry, a process for which many illustrations could be cited. It is possible that easier credit conditions might have weakened the incentive towards this very necessary process of reorganization.

(4) It would have been foolish for the Italian authorities to try to compensate for the overvaluation of the £ sterling prior to September 1949 by raising the internal price level at the cost of endangering their ability to maintain the lira rate for the dollar, which they had succeeded in keeping stable since the beginning of 1948.

Whatever the arguments were for and against a more liberal credit policy in the first half of 1949, the Italian government had decided by the middle of the year to engage on an investment program using the counterpart funds. Detailed plans were drawn up which only awaited the approval of the American authorities before being put into effect.

III. The Balance of Payments

The movement of the Italian balance of payments on *ordinary* current account over the period 1946-48 is shown in Table V. For purposes of comparison we also show the balance of the various items for 1938.

The items on *extraordinary* current account consisting on the

[1] In July the index of industrial production fell slightly, but this is probably attributable to the electricity cuts caused by the drought.

TABLE V

BALANCE OF PAYMENTS ON ORDINARY CURRENT ACCOUNT
(Millions of dollars)

	1938	*1946*[1]			*1947*			*1948*		
	Balance	*Credit*	*Debit*	*Balance*	*Credit*	*Debit*	*Balance*	*Credit*	*Debit*	*Balance*
Merchandise (f.o.b.)[2]	—115.9	478.6	757.0	—278.4	665.6	1,326.9	—661.3	1,067.6	1,388.0	—320.4
Tourism[3]	+68.8	2.0	—	+2.0	6.8	0.4	+6.4	26.3	2.4	+23.9
Shipping	—3.6	27.0	166.7	—139.7	92.7	254.2	—161.5	128.3	240.0	—111.7
Remittances from emigrants and workers abroad	+37.6	45.0	—	+45.0	34.1	—	+34.1	84.9	—	+84.9
Other invisible items[4]	—33.0	14.0	13.0	+1.0	29.5	36.0	—6.5	99.1	48.5	+50.6
Total	—46.1	566.6	936.7	—370.1	828.7	1,617.5	—788.8	1,406.2	1,678.9	—272.7

[1] For 1946 the figures are only very rough.

[2] In 1948 the break-up of Italian imports and exports between food products, raw materials, semi-finished goods, and finished goods, was as follows:

	Imports	*Exports*
	Per cent of total	
Food products	44.2	18.8
Raw materials	36.2	6.0
Semi-finished goods	12.3	26.7
Finished goods	7.3	48.5
	100.0	100.0

For imports the percentages are based on the c.i.f. figures.

[3] The income from tourism and from some other items is probably considerably underestimated since the figure given does not, of course, include the foreign exchange which flowed into the black market. The exchange which in this and other ways escaped the authorities tended, however, to be "repatriated" through *franco valuta* imports, especially in 1947 (see p. 30 below).

[4] Insurance, income on investments, government transactions, etc.

credit side of grants and gifts,[1] and of sums credited to Italy in respect of services rendered to the Allied military authorities,[2] and on the debit side of reparations and other obligations under the Peace Treaty, and of the use by other countries of drawing rights granted by Italy under the European Payments Scheme were as follows:

TABLE VI

BALANCE OF PAYMENTS ON EXTRAORDINARY CURRENT ACCOUNT
(Millions of dollars)

	1946	*1947*	*1948*
Grants and gifts	544.8	277.2	411.5
Services to Allied authorities	74.0	120.1	15.6
Reparations and other obligations	—	—4.1	—27.6
Drawing rights	—	—	—14.3
Total	618.8	393.2	385.2
Difference between Total of Balance in Table V and Total of Table VI	248.7	—395.6	113.5

Thus we see that in 1946 the surplus on extraordinary current account more than covered the deficit on ordinary current account. Another credit item which we have to add in that year is the figure for *franco valuta* imports (*i.e.* imports financed by foreign exchange not obtained through the official channels)[3] amounting to about 40 million dollars. There were also a number of items on capital account: Italy received a loan from the Export-Import Bank, a credit for the purchase of American war surplus material, and certain other credits. In addition she ran into debt on her clearing accounts to an amount equivalent to 18 million dollars.

The net result of all the transactions on ordinary and extraordinary current account, of imports *franco valuta*, and of the borrowing transactions on capital account, was that Italy was able to build up reserves of "free" foreign exchange (*valute libere*) consisting mostly of dollars and sterling. The accumulation of sterling in 1946 (at the end of that year Italy had sterling reserves of

1 Mostly UNRRA and FEA in 1946, UNRRA and AUSA (post-UNRRA) in 1947, and Interim-Aid and ERP in 1948.

2 *i.e.* the Troop Pay Fund, the Suspense Account and prisoners' scrips, and dollars credited to Italy in respect of lira sums furnished to the American military authorities.

3 Cf. p. 30 below.

£32.3 millions) was in part, however, involuntary in the sense that it was due to Italy's difficulty in obtaining deliveries of urgently needed supplies of raw materials from the sterling area because of the general scarcity of those materials, and her inability to obtain them outside the area because of the inconvertibility of sterling.

In 1947 the heavy deficit on ordinary current account far exceeded what could be covered by the surplus on extraordinary current account, and Italy, besides obtaining credits from the United States and Argentina, had to draw on the dollar reserves which she had accumulated in the previous year. The Report of the Governor of the Bank of Italy for 1947 gives us a detailed account of the balance of payments for that year including not only the ordinary and extraordinary current accounts shown in Tables V and VI above, but also the capital account items. These are shown in Table VII.

TABLE VII

CAPITAL ACCOUNT FOR 1947

	Debit items	*Credit items*
	(Millions of dollars)	
Net borrowing on ordinary loan account	187.6[1]	
Net surplus on clearing account		21.6
Decrease in "free" foreign exchange reserves	93.3	
Increase in gold reserves		27.4
Total	280.9	49.0
Net capital import	231.9	

[1] Made up of: drawing on loan from Argentina net of temporary accumulation of credits in Argentina by *Federazione dei Consorzi Agrari* (35.0), *plus* credit for purchase of ships and American war surplus material (108.0), *plus* drawing on Eximbank credit for purchase of cotton and tobacco net of repayments (4.4), *plus* value of raw materials supplied by foreigners for processing in Italy (43.8), *minus* payment of Italy's participation in the Bank for International Reconstruction (3.6).

In addition we have the following items which are akin to capital repatriation or to capital import:

	(Millions of dollars)
Funds repatriated through *franco valuta* imports	114.0
Borrowing through temporary excess of imports due to "lame" (*zoppe*) private compensations[1]	29.0
	143.0

[1] "Lame" private compensations are private compensations in which only one side of the transaction has been performed in the period considered. Thus some

Thus in 1947 the total of the surplus on extraordinary current account, *franco valuta* imports, "lame" private compensations, and capital import (including the loss of foreign exchange reserves) was 768.1 million dollars, which is almost equal to the deficit on ordinary current account of 788.8 million dollars (the difference being due to errors and omissions). We notice that in order to achieve this balance Italy had to draw down her reserves of "free" foreign exchange *plus* gold by the equivalent of 65.9 million dollars.

In 1948 the deficit on ordinary current account was, as we have seen, very much smaller than it had been in 1947, and was more than covered by the extraordinary current account items. The Governor's Report for 1948 does not give us the figures for the capital account. It tells us, however, that Italy had a surplus on clearing account for the year equivalent to 104.5 million dollars, an increase in her "free" foreign exchange reserves equivalent to 141.5 million dollars,[1] and an increase in her gold reserves of 36.4 million dollars. And, as special items helping to cover the deficit on current account, there were funds repatriated through *franco valuta* imports amounting to 92 million dollars, and borrowing in the form of an excess of imports due to "lame" private compensations amounting to 29 million dollars.

Recapitulating the movements of Italy's foreign exchange position over the three years, we observe that in 1946 she accumulated "free" exchange reserves, but ran into debt on clearing account; in 1947 she paid off her debt on clearing account but lost large amounts of "free" foreign exchange reserves; in 1948 she acquired credits on clearing account and also reconstituted her "free" foreign exchange reserves.

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imports in the current year may have been paid for by exports made in the previous year, or they may be paid for by exports to be made in the next year. Similarly some current exports may not be matched by current imports. We may thus have an excess during any calendar period of "lame" imports over "lame" exports, or *vice-versa*. Probably, also, some of these private compensations remained permanently "lame."

1 Made up of an increase in dollar reserves of 142.1 million dollars, an increase in Swiss franc reserves equivalent to 3.0 million dollars, and a reduction in sterling reserves equivalent to 3.6 million dollars.

IV. Foreign Exchange Policy

Italy's foreign exchange policy since the war may be divided into four stages. The first was the phase of "abnormality" which lasted until the end of November 1947. It was characterized by multiple exchange rates for each of the principal currencies, and by rates for other currencies which were frequently out of line with real conditions, tending as a rule (at least until August 1947) to overvalue the lira. The second is the phase characterized principally by the unification of the rates for the dollar (and the Swiss franc), and by the stabilization of the unified rate. The third is the phase of the "alignment of the cross rates" to this new dollar rate, producing a situation in which the lira tended to be undervalued in terms of the principal European currencies. The fourth is the phase ushered in by the devaluation of the £ sterling on September 18th, 1949.

Distinction between "Free Currency" and "Compensation" Areas

Throughout the period we have to distinguish two principal currency "groups," and several types of exchange transaction. The principal groups of currencies are: (a) The group of the so-called "free currencies" (*valute libere*). These were the currencies which were from the beginning regarded as the "hard" currencies from Italy's point of view, and originally comprised the dollar, the £ sterling, the Swiss franc, the Egyptian pound, and the Portuguese escudo. (b) The group of currencies for which the rates were fixed in the bilateral commercial and payments agreements, into which Italy entered with most countries of Continental Europe from 1946 on.

These agreements have provided for two types of compensation: (1) Initially at least, they contemplated that trade would take place primarily through compensations of the so-called "monetary type," *i.e.* that settlements would be made through general clearing accounts kept by the *Ufficio Italiano dei Cambi* (hereafter referred to as the UIC) in Italy, and by the corresponding institution of the other party to the agreement. In order to avoid the necessity for rigid bilateralism they customarily allowed for credit margins, and in some cases also for the periodic settlement of any deficits over and above the credit margin in gold or "free" exchange.

(2) Alongside the provision for compensations of the monetary type, however, provision was usually also made in such agreements for "reciprocity deals" which are barter transactions, each transaction having its own "implicit" rate of exchange calculated through the prices in national currencies of the goods exchanged. Each reciprocity deal is settled through a special sub-account of compensation opened for that deal by the UIC in Italy and by the corresponding institution in the other country.[1] The original purpose of the provision for reciprocity deals was to allow trade to continue when for some reason or other (*e.g.* exhaustion of the quotas fixed in the agreement, or exhaustion by one of the parties of the credit margin and its unwillingness to meet further deficits in the clearing by payment in gold or "free" exchange) it might otherwise come to a standstill until a new agreement could be negotiated. As we shall see, the importance of reciprocity deals as a means of conducting trade has varied, and with certain countries at certain times Italy's commercial transactions have been reduced entirely to a reciprocity deal basis, compensations of the monetary type being altogether set aside. The reciprocity deal method of doing trade came in fact to be used as an instrument for allowing the effective exchange rates between the lira and the currencies of other countries to move away from the official rates, at which rates it proved impossible to achieve a balance of trade between Italy and those countries on a bilateral basis. The method was so used first at a period when the official rates generally tended to overvalue the lira, and later at a period when they tended to undervalue the lira.

Finally, some transactions have been conducted on a private compensation basis. In contrast to the reciprocity deal, a private compensation is settled privately between the individual importer

[1] Thus if an Italian exporter exports to France merchandise valued at 1,000 lire and an Italian importer receives, as the counterpart to the reciprocity deal, imports valued at 500 French francs, the Italian exporter receives the 1,000 lire paid into the sub-account of compensation at the UIC by the Italian importer, and the French exporter receives the 500 French francs paid by the French importer into the corresponding account in France. The rate of exchange is then 2 lire = 1 French franc.

and the individual exporter on each side, and is thus subject to less supervision by the authorities. Private compensations have been used principally with countries (*e.g.* until recently with Austria) with which it was not possible to reach any agreement either for general compensations of the monetary type or for reciprocity deals. They have also been allowed in certain special cases with other countries.

Establishment of Free Market and Multiple Rates for "Free" Currencies

After the landing of the Allied armies in Sicily, the rate of 100 lire to the dollar was established as the official rate of exchange,[1] with corresponding rates for other currencies. In January 1946 the official rate for the dollar was in effect raised to 225 lire,[2] and the official rates were correspondingly raised for the other currencies. In February private foreign trade was resumed. At the end of March, for certain currencies, the *valute libere* or "free" currencies (*i.e.* the dollar, the £ sterling, and the Swiss franc),[3] a partial free market was established in which the rates were allowed to find their own level. Thus was initiated the policy of flexible exchange rates to which Italy has throughout adhered as the most effective method of finding a new equilibrium in her international accounts.

The establishment of a legal free market in these currencies took place through the introduction of the so-called 50 per cent system. Under this system exporters were obliged to sell to the UIC, at the official rate of exchange, 50 per cent of the proceeds of their exports, while the remaining 50 per cent was credited to their foreign exchange accounts (*conti valutari*) at banks authorized to deal in foreign exchange. The exporters could then either use these accounts to pay for their own imports, provided they

[1] In 1938 the rate was 19; at this rate, however, the lira was considered to be overvalued.

[2] This rate was called the "official rate increased by the additional quota of 125 per cent."

[3] Among the "free" currencies were also the Egyptian pound and the Portuguese escudo. The rate for the first was calculated on the basis of the legal parity of that currency with sterling, and the rate for the second on the basis of the legal parity of that currency with the dollar.

had the requisite licenses, or sell them in the free market of Rome or Milan, through the agents of the authorized banks, to other importers with the requisite licenses. The exporters were obliged to dispose of the sums credited to their foreign exchange accounts within 90 (later 60) days from the date when the account was credited. The foreign exchange which the UIC acquired under this system was used for the most part to finance imports made by, or on behalf of the government; these consisted of "essential" goods such as wheat, coal and oil.

The quotations for the "free" currencies on the legal free market began in May (1946), and these first quotations were well above the official rates (see Table XI). There were thus effectively three legal rates for the dollar, and similarly for the £ sterling and the Swiss franc:

(a) the official rate (225 Lit. = $1) at which government imports were paid for, and at which exporters sold half of their export proceeds;

(b) the "free" rate at which all other imports were paid for, and at which exporters sold half of their export proceeds (this rate is also referred to as the *cambio di esportazione* or export rate);

(c) the effective rate received by exporters, which was equal to the arithmetic mean between (a) and (b).[1] We shall refer to this rate as the "middle rate."

Since the free rate was always above the official rate, exporters had to pay a higher rate for their imports than they received from their exports. And private imports were in effect taxed for the benefit of government (essential) imports.

The course of the free rate, as we shall observe below, could be, and was kept within certain limits by controls exercised through:
(i) The manipulation of the licensing system. Two categories of import license existed: commodities on List A required only a "customs license" (a simple formality) whereas those on List B required a "ministerial license," which was much more difficult to obtain. By shifting commodities from one list to the other, and by varying the strictness with which "ministerial licenses" were

[1] The new system was only gradually extended to non-commercial transactions. Thus it was extended to receipts of shipowners in August 1946, and to tourist receipts, emigrants' remittances, and capital transfers to Italy, in January 1947.

granted, the demand for foreign exchange could be decreased or increased.

(ii) The use of the *franco valuta* system. This was originally introduced in March 1946, and was a system under which the government allowed certain imports (mostly of food products) to take place without any application being made for foreign exchange through the official channels. It was a method of encouraging the repatriation of capital held abroad before March 1946, and also, what was probably more important, of encouraging the rapid repatriation of foreign exchange which currently evaded the controls. By increasing the number of licenses granted for *franco valuta* imports, the government could increase the supply of foreign exchange from this source and thus reduce the pressure on the legal free market; for the high profits to be made on imported goods during this period acted as a strong inducement to holders of balances abroad to repatriate them in this manner.[1]

(iii) The granting at certain times of permission to exporters in certain sectors to sell more than 50 per cent of their foreign exchange on the free market.

(iv) The accumulation or decumulation of official foreign exchange reserves.

From May to October 1946, the legal free rates for the *valute libere* rose rapidly, the average rate for the dollar in October reaching 600. The rate fell back slightly in the next few months, partly owing to the shifting from List A to List B of cotton and wool, for which there was a heavy demand for replenishing the stocks of the textile industry. From March 1947 on, however, the lira again depreciated rapidly. This was due partly to the shifting back of cotton and wool to List A, but mainly to the effect of the internal inflation on domestic prices and costs, of the heavy restocking boom associated with it, and of the speculation on a further fall in the value of the lira which encouraged evasion of the exchange control. The maximum free rate for the dollar was reached in May (1947), the average level for that month being

[1] The *franco valuta* system as a means whereby Italian citizens might without penalty repatriate capital illegally held abroad before March 1946 continued in force until the middle of 1948. Since then the *franco valuta* system has been used only in exceptional cases.

905. The black market rate for notes also reached its maximum in May with an average level of 801. From this time on the rate recovered, mainly as a result of the greater confidence placed in the new government which came into office at the beginning of June, and of the announcements concerning its internal financial policy which created the expectation that the inflation was going to be brought to an end. Thus speculators began to hold off from further accumulation of inventories of imported raw materials, and also were more ready than before to sell their foreign exchange holdings. Also the government took direct measures to increase the supply of foreign exchange relatively to the demand on the free market. This was done by giving various sectors (exporters of cotton and woolen goods, and shipbuilders) permission to sell more than 50 per cent of export proceeds on the free market, by tightening up the granting of licenses for imports financed with foreign exchange bought on the legal free market, and liberalizing the granting of licenses for *franco valuta* imports. By August the legal free rate for the dollar (average for the month) had fallen to 721.

The rates fixed in clearing agreements were throughout the period we have been discussing still based on the "official" rates of exchange for the respective currencies, equivalent, that is to say, to a cross rate of 225 Lit. = $1. This meant that during the greater part of the period there was a very wide discrepancy between the rates in the *valute libere* area and the rates in the compensation area. The discrepancy tended to distort the flow of trade by making it profitable to import from the compensation area in preference to the *valute libere* area and to export to the *valute libere* area in preference to the compensation area. In consequence, even in 1946 Italy's clearing accounts with most countries (all except that with Spain) went against her, her credit margins were used up, and, in order to avoid a drain of *valute libere* to cover the deficit in the compensation area, recourse was had with some countries (Sweden, and to a lesser extent Norway) to reciprocity deals. The implicit lira rates for the foreign currencies in these deals were considerably higher than the official rates, as may be seen from the table below:

TABLE VIII

	Official Clearing Rate	*Rate in Reciprocity Deals at End of 1946*
	(In lire per unit of the foreign currency)	
Swedish krone	62.5	100
Norwegian krone	45.4	73

The tendency for Italy to run into debt on clearing account continued in the first part of 1947, and trade with the compensation area was being reduced more and more to a reciprocity deal basis. The persistent gap between the official rate and the free rate for the *valute libere* also acted as a factor hindering exports to the *valute libere* area, since it meant that what exporters obtained for their exports to that area was proportionally much smaller than what they had to pay for whatever materials they needed to import from that area.

Early in August, in order to reduce the gap between the official and the free rates, the official dollar rate was raised from 225 to 350 Lit. (and similarly for the other *valute libere*), and most[1] of the clearing rates were also adjusted to correspond to this new rate.[2] So far as the greater part of the compensation area was concerned, this meant a devaluation of the lira by over 50 per cent. From this moment on Italy's clearing debts began to fall rapidly from the maximum which they had reached at the end of July.[3] This was despite the fact that some part of the effect of the devaluation was counteracted by a further rise in internal prices and costs in August and September.

[1] The clearing rate for the Belgian franc had been changed in June (1947) when it was linked to the "middle" rate for the dollar in Italy (the mean between the official rate and the fortnightly average of the free rate) and the official rate for the dollar in Belgium. Rates tied to the "middle" rate for the dollar were also applied to the Anglo-American and Soviet Zones of Germany, to Argentina (by the agreement of October 1947), and to Poland for exchanges of certain Italian goods against Polish coal.

[2] At the same time the tax on import licenses was raised from 5 to 10 per cent. Since Italy's import duties before the war were specific duties, they became ineffective as a result of the inflation, and the tax on import licenses has acted in place of a tariff, pending the formulation of a new tariff schedule. Certain commodities were exempt from the application of the 10 per cent tax.

[3] By the end of 1947, following the devaluation of the lira in August, and the fall of lira prices from October on, Italy's net debt on clearing account had been entirely removed. As we have seen, however, the year closed with a heavy loss of "free" foreign exchange by Italy compared with what she had held at the end of 1946.

In October internal prices began to decline as a result of the policy of credit restriction described in Section II above; and by November the lira rate for the dollar in the legal free market had fallen to an average of 603.

Unification of Rates for Dollar and Swiss Franc

The government now decided that the moment had come for a unification of the rates for the dollar (and the Swiss franc), and this brings us to the eve of the second phase of Italy's foreign exchange policy since the war, the phase introduced by the Decree of November 28th, 1947.

Under this Decree the UIC was to acquire its quota of the proceeds of exports to countries with *valute libere* at a price which, instead of corresponding to the official rate of 350 Lit. to the dollar, was to be equal to the average for the preceding month of the quotations on the "free" market for the respective currency. The quota of export proceeds to be ceded to the UIC became once more a unique proportion, *i.e.* 50 per cent to apply to all categories of exports.[1]

Differences between the "middle" rate at which the exporters sold their foreign exchange and the legal free rate at which importers bought it, could henceforth exist only in so far as the legal free rate fluctuated. In fact, from the time when the new system was inaugurated, up until the devaluation of the £ in September 1949, the variation in the free rate was negligible, varying between the narrow limits of 573 and 575. The UIC, of course, besides providing the foreign exchange for government imports, acted as a stabilization fund, buying and selling foreign exchange in the free market in order to keep the dollar rate stable. And it used part of the dollar exchange it acquired to build up Italy's dollar reserves.

The third phase of Italy's foreign exchange policy is the phase of the alignment of the cross rates for other currencies to the new "middle" rate for the dollar.

We have seen that as a result of the new system introduced at the end of November 1947, the lira rate for the dollar became for

[1] The same rules applied to the foreign exchange proceeds of financial transactions.

all practical purposes a uniform rate in place of the multiplicity of rates that had existed previously, and similarly for the Swiss franc.[1] The rate for the £ sterling continued to fluctuate on the free market, and consequently there persisted a difference between the legal free rate and the UIC rate; and both the "free" rate and the "middle" rate for the £ gave a cross rate between the latter and the dollar which was far below the official parity of 4.03. Also, the rates of exchange in the major part of the compensation area were, at the end of 1947, still linked to the old official rate of Lit. 350 to the dollar instead of to the new 575 rate. It was the desire both of the International Monetary Fund, and of the government of the United Kingdom to see the lira rates for the various currencies brought into line with the new rate for the dollar, on the grounds that "disorderly" cross rates cause distortions in the flow of trade. In particular, the United Kingdom objected that they opened the way to arbitrage operations, involving the purchase by Italy (as also by France after the introduction of the new French exchange policy early in 1948) of goods from the sterling area with "cheap" sterling and their sale in the United States for dollars, with a corresponding loss of dollars to the sterling area.

Alignment of Cross Rates in "Compensation" Area

Between December 1947 and March 1948 Italy adjusted to the new dollar rate the rates in her clearing agreements with Argentina, the Bizone and the Soviet Zone of Germany, Sweden (but for financial transactions only), Poland, Belgium and France.

As regards Argentina, Belgium, the two zones of Germany, and Poland, the clearing rates had, as we mentioned earlier, been previously tied to the old "middle" rate for the dollar (*i.e.* the average between the "free" rate and the 350 rate), and hence the upward valuation of the relevant currencies in terms of the lira which now took place was proportional to the increase in the "middle" rate for the dollar. The upward valuation of the Swedish krone, since the rate had previously been tied to the 350 rate, was of course greater, but the new rate was, as we have already remarked, confined to financial transactions, commercial transactions being

[1] The rate corresponded to the cross rate between the lira rate for the dollar and the "financial" rate for the dollar in Switzerland.

placed on a reciprocity deal basis. Similarly, in the case of the French franc the adjustment meant that the rate was raised (in March) from 1.6 to 2.20 (later 2.15) lire per French franc; the new devaluation of the lira thus almost wiped out, so far as Italy was concerned, the effect of the devaluation of the French franc at the end of January 1948, which had reduced the lira rate for the franc from 2.34 to 1.6 lire.

The effect of the devaluation of the lira in terms of the currencies of the countries in the compensation area was to encourage exports to those countries and discourage imports from them, and to turn the clearing accounts in Italy's favor. Thus Belgium very soon exceeded the credit margin (of 100 million Belgian francs) allowed for in her agreement with Italy, and since Belgium was unwilling to settle the excess in dollars, trade between the two countries was temporarily (from September 5th to December 5th, 1948) placed on a reciprocity deal basis, until a new agreement was reached amounting in effect to the granting of a new credit margin. For the Bizone the credit margin was likewise exceeded until a higher margin was conceded. France also, despite the fact that she received reparations payments from Italy and also used drawing rights granted by the latter, exhausted her credit margin until Italy agreed to increase it; finally, in March 1949, it was decided to reduce the lira-franc rate from 2.15 to 1.80[1] lire per franc. With Argentina also Italy accumulated a large credit in the clearing, so that what she has lent back to Argentina in this form largely covers what she previously drew on the credit granted to her by that country. In fact, by the end of 1948 Italy had credit balances with almost all those clearing countries with which she did any considerable volume of trade, and her position was thus the reverse of what it had been in 1946 and the first nine months of 1947.

For Holland it was never regarded as possible, given the relative price levels, to establish a general clearing rate which was in

[1] This rate corresponded to the cross rate between the rate of 575 lire to the dollar and the "free" rate for the dollar in France, instead of to the cross rate between the 575 rate and the "middle" rate in France (or, that is, the average between the official and free rates).

line with the official dollar cross rate, and instead all commercial transactions were in March 1948 placed on a reciprocity deal basis. Commercial transactions with Denmark,[1] had with few exceptions been on a reciprocity deal basis since May 1947.[2] In the case both of Belgium and France reciprocity deals have taken place alongside the monetary compensations.[3]

The implicit rates of exchange underlying these reciprocity deals differed considerably from the rates that would have corresponded to the "correct" dollar cross rates, as may be seen from the following table which shows the minimum and maximum reciprocity deal rates registered in the month of December 1948, and, for comparison, the rates corresponding to the official dollar cross rates at that date. We see that these reciprocity deal rates gave lira values for the foreign currencies which were much lower than those required by the alignment of the cross rates.

TABLE IX

	Reciprocity Deal Rates in December 1948		*Rate Corresponding to Official Dollar Cross Rate*
	Min.	*Max.*	
	(In lire per unit of foreign currency)		
Belgium	10.0	13.1	13.11
France	1.4	2.2	2.15[1]
Denmark	60.0	87.0	119.5
Holland	120.0	190.0	216.2
Norway	80.0	90.0	115.7
Spain	21.0	32.0	51.2
Sweden	85.0	120.0	159.7

1 Based on the "middle" rate for the dollar in Paris.

1 Financial payments with Holland and Denmark are tied to the rate for sterling.

2 Such transactions as took place through general compensation were conducted at a rate of exchange which still corresponded to the old official dollar rate of 350. Similarly for commercial transactions through the clearing with Spain.

3 In May 1949, general compensation (clearing) agreements were in force with the following countries: Argentina, Belgium, the Bizone, the French and Russian Zones of Germany, Greece, Hungary, Norway, Poland, Roumania, Spain, Turkey, the U.S.S.R., Yugoslavia. Agreements to trade on a reciprocity deal basis existed with Austria, Bulgaria, Denmark, Holland, Sweden, and, for part of the trade, with Switzerland. Reciprocity deals were also permitted with some of the countries in the general compensation group, *i.e.* with Belgium, France, Norway, Spain and Turkey. Private compensations were the rule for trade with Czechoslovakia, and were allowed also in special cases with some other countries (mostly in Central and South America).

Alignment of Cross Rate for £ Sterling

So far we have spoken only about the alignment, early in 1948, of the cross rates for the currencies in the compensation area. We have still to consider the alignment of the rate for the £ sterling which had still more serious consequences for Italy. In April 1947 an agreement had been concluded between Italy and the United Kingdom whereby the £ was made convertible for Italy, and the Italian government undertook to guarantee the cross rate for the £ with the dollar via the lira corresponding to the official parity of 4.03. After the general suspension of convertibility of the £ in August (1947), this agreement was abrogated, and the £ was allowed to depreciate in the Italian legal free market. In November 1948 a new Anglo-Italian Sterling Payments Agreement was reached under which the UIC again undertook to guarantee the 4.03 cross rate. In consequence sterling ceased to be a *valuta libera* in the Italian foreign exchange market, exporters henceforth sold to the UIC not half but the whole of the proceeds of their exports to the sterling area, and all Italian importers from the sterling area were obliged to buy their sterling from the UIC.

The agreement meant a sharp increase in the lira rate for sterling, and hence for all sterling area currencies, and the Egyptian pound.[1] In January 1948 the legal free rate for the £ had averaged 1,755 Lit., giving a cross rate with the dollar of 3.06, and the "middle" rate had averaged 1,696, giving a cross rate of 2.95. The rates subsequently rose, in anticipation of the establishment of the 4.03 cross rate, and became a unified rate of 2,317 Lit. to the £ when that cross rate was finally established. Sterling thus became roughly 30 per cent more expensive than it had been in January. The Italian price level, as we have seen, had throughout this time remained almost stable.

We shall here consider the movement, following the change in the lira-sterling rate, of the balance of trade between Italy and

[1] The agreement stated that "All trade and financial payments between residents of Italy and residents of the Scheduled Territories" (sterling area) "shall be settled in sterling." But since sterling transfers without restriction exist also between Italy and Egypt, the Anglo-Egyptian Sudan, Siam and Ethiopia, these four countries must also be included for our purpose. We shall refer to them as "assimilated territories."

the sterling area (*plus* the "assimilated territories"), and of Italy's sterling balances. In Table X we show the balance of trade between Italy and the sterling area *plus* "assimilated territories" for the whole of 1948, and for the first seven months of 1948 and 1949 respectively, the July figures being the latest so far available for 1949. From these figures it appears that Italy had in the first seven months of 1949 an export surplus towards the area which was almost as large as her export surplus for the whole twelve months of 1948, despite the fact that the latter owing to the normal seasonal movement, occurred almost entirely in the last five months of the year.

TABLE X

TRADE BETWEEN ITALY AND THE STERLING AREA *plus* ASSIMILATED TERRITORIES[1]
(Billions of lire)

	Jan.-Dec. 1948	*Jan.-July 1948*	*Jan.-July 1949*
Italian imports[2] from sterling area and assimilated territories	122.4	63.4	101.2
Italian exports to sterling area and assimilated territories	140.6	66.1	118.1
Balance	+18.2	+2.7	+16.9

[1] Source: *Statistica del Commercio con l'Estero*, published by the *Istituto Centrale di Statistica.*
[2] C.i.f. figures.

It has been pointed out by the United Kingdom authorities that, although trade between Italy and the sterling area showed an even balance in the early months of 1949,[1] Italy's sterling balances accumulated very rapidly during that period. Indeed, whereas in the first eleven months of 1948 (as a result of the expected upward valuation of the £) her sterling balances had declined, they began accumulating from December onwards. At the end of December they amounted to about £ 30 millions: in September 1949 they were reported to amount to over £ 70 millions.[2]

[1] For January to May the Italian figures showed imports from the sterling area and "assimilated territories" of Lit. 77.1 billions against exports of Lit. 77.2 billions.

[2] In consequence of the accumulation of sterling, Italy was never in a position to use the "drawing rights" extended to her by the United Kingdom. On the other hand, drawing rights extended by Italy to Belgium, France, Greece, the Bizone,

Several causes probably contributed to this heavy accumulation of sterling:

(1) There was some carry-over from the end of 1948, because importers paid for some of the imports which are registered in the 1949 statistics in the months preceding the upward valuation of sterling, so as to avoid the higher rate for sterling.

(2) The prospect of a possible devaluation of the £ caused importers to delay payment as long as possible (by using acceptance credits for three months or longer) and exporters to negotiate their sterling as soon as possible.

(3) Italy probably obtained some "transferable account" sterling through the official channels in payment from countries outside the sterling area (and outside the "assimilated territories").

(4) The increase in the lira rate for sterling encouraged arbitrage operations through which Italian importers from the sterling area contrived to evade the higher price for sterling by acquiring it through unofficial channels. It is likely that many of these operations took place, at least until February, through a combination of the black market in dollars, the "unofficial" market in sterling, and "lame" private compensations. Thus, for example, an importer would obtain a license for carrying out a private compensation, which by its nature involves no application for foreign exchange through official channels and no declaration of the way in which payment for the import is effected. In fact the importer bought dollars in the black market and used them to buy sterling at the unofficial rate. The black market dollars were in turn furnished by an export to the dollar area (or to some other country from which payment could be obtained in dollars), also made under a license for a private compensation. The two operations might, of course, still appear as a private compensation of which both sides had been fulfilled; but it was a triangular compensation instead of a bilateral one. As a result of such operations the UIC failed to sell a corresponding amount of its sterling balances, and failed to acquire an equivalent amount of dollars.

In consequence restrictions were placed on private compensa-

Turkey, the French Zone, Norway and Sweden, amounting for the year October 1st 1948-September 30th 1949 to a total of $47.3 millions had been used to the extent of $38.2 millions in the first nine months (*i.e.* up to the end of June 1949).

tions in February 1949.[1] All private compensations must henceforth be bilateral, and, to assure that they were so (*i.e.* that the country of destination of the export coincided with the country of origin of the import), and to prevent their being "lame," a new control of documents by the UIC was instituted. Both sides of the transaction were required to be performed within three months of the issue of the permit for the compensation. Although these regulations undoubtedly reduced the volume of arbitrage transactions, they could not prevent them entirely.

In the first half of 1949, while Italy's sterling and dollar balances continued to increase, her credit balances with the compensation area were considerably reduced. This was due to a variety of causes: the adoption by Italy of a more liberal import licensing policy towards the compensation area; the relaxation by some countries in that area (*e.g.* France) of restrictions on exports of certain products to Italy; the readjustment (in March) of the lira-French franc rate; and, possibly, also, the transfer by Italian importers of some purchases from the sterling area to the compensation area (*e.g.* to Belgium) in consequence of the upward valuation of the £.

The accumulation of further dollar balances was regarded as necessary in order to provide a cushion for the time when Marshall aid comes to an end. The continued accumulation of sterling balances, on the other hand, rapidly brought the latter to a level which the Italian authorities regarded as exceeding what are necessary as working balances with the sterling area. In September they probably amounted to the equivalent of eleven months' imports from the sterling area and "assimilated territories," on the basis of the rate of imports registered in the first seven months of 1949 and the pre-devaluation exchange rate. For this and other reasons, *i.e.* the inflationary pressure of the advances which the Bank of Italy had to make to the UIC for financing the growth of these balances,[2] and also the fear of devaluation of the £, which would mean losses for the UIC, the Italians wished to avoid further accumulation. However, under the agreement with the United Kingdom of November 1948, no ceiling had been set to the debt

[1] Following this the black market rate for the dollar fell.
[2] Cf. Section II.

which the sterling area might incur towards Italy. The UIC undertook to "purchase, when required, sterling transferred to the credit of any Italian Account against disbursement of the lira equivalent." This situation was not changed in the new agreement negotiated in July 1949.

It has been repeatedly argued by British spokesmen that Italy was to blame for the accumulation of excessive sterling balances by the fact that she granted licenses for imports from the sterling area too unwillingly. There appears to be little foundation for this contention. In fact Italy took several steps aimed at reducing her sterling balances by facilitating sterling imports. After the end of 1948 there was a considerable liberalization of the granting of licenses for imports from the sterling area. Most of the imports from the area (including wool, jute, rubber, tin) were placed on the list of goods which can be imported under a "general open license," the only document required being a banking authorization (*benestare bancario*) showing that payment has been, or is to be made in sterling. It is true that until recently imports of machines and tractors still required a special license. Following the new agreement of July, however, the Italian authorities agreed to follow a more liberal policy with respect to these goods also. Finally, (in July) they were preparing to grant loans at low rates of interest[1] for machines and ships purchased from the United Kingdom. Since the interest rate on such loans was to be only about half the rate normally charged on commercial loans, this would have been equivalent to the granting of an Italian subsidy on imports of British goods. Whether, now that sterling has been devalued, this scheme will be put into effect is not yet known.

Towards the end of September, the Italian government formally abolished import licensing for a list of approximately one hundred items imported from OEEC countries, affecting about 45 per cent of Italian imports from those countries. On the basis of the information available to us at the time of going to press we are not able to determine whether this action really amounts to a further

[1] The loans were to be given on the same terms as those on which loans are granted in respect of machines imported from America under ERP grants. The loans for ERP machinery are granted by the Treasury (on the basis of the "lira fund") through the *Istituto Mobiliare Italiano* for terms of 6-25 years at 5.5 per cent.

liberalization of trade, compared with what had already been achieved with respect to the United Kingdom (as part of the sterling area) and the compensation area in 1948-49. It should, moreover, be recalled that the new Italian tariff will soon come into operation, involving, for some commodities, a considerable increase in import duties.[1]

Summary of Results of Foreign Exchange Policy to September 1949

Certain conclusions of general interest can be drawn from Italy's experience in the field of foreign exchange policy between the end of the war and the devaluation of the £:

(1) Once internal prices and costs had been approximately stabilized, the level of imports and exports was very sensitive to changes in the foreign exchange value of the lira. In fact the balance of payments responded immediately both to the changes made in the latter part of 1947 and to those made in 1948. On each occasion the devaluation of the lira led to the reduction of Italy's debit balances or to an increase in her credit balances with other countries. Italy's experience thus offers no support to the widespread notion that the combined elasticities of a country's home demand for imports and of the foreign demand for that country's exports will as a rule be insufficient to bring about an improvement in its balance of payments in response to a devaluation of its currency, and still less to the notion that its balance of payments will actually be worsened by the devaluation.

(2) Correct cross rates, which are the natural concomitant of a system of convertible currencies and multilateral trade, are, in principle, incompatible with a system of bilateral agreements and inconvertible currencies. As Professor Bresciani-Turroni wrote early in 1948, uniformity of cross rates "as things are at present, would be, in a manner of speaking, a foreign body introduced into a system which, owing to the prevalence of bilateral agreements, logically accepts a difference in cross rates in various countries," and it is not the disorderly cross rates which are responsible for distortions in the flow of trade; on the contrary, it is the distortions caused by bilateral agreements "that render(s) a general equi-

[1] Cf. footnote 2 on p. 32.

librium of foreign exchange rates impossible."[1] We have seen that in the case of Italy, the alignment of the cross rates created its own distortions. It led to the persistent accumulation by Italy of balances abroad which had to be arrested either (a) by a reversion to barter transactions (reciprocity deals), which carry their own exchange rates, so that the official rates established by the alignment of the cross rates ceased to be the effective rates at which trade took place, or (b) by a readjustment of the official rate away from the level equivalent to the "correct" cross rate (as was done with respect to France), or (c) by a form of subsidization of certain imports (as was proposed for certain goods imported from the United Kingdom).

(3) As things were in the middle of 1949 it seemed that Italy had established a dollar rate which was "realistic" in terms of the relative price levels of the respective countries, but that, on the basis of the experience of the preceding eighteen months, the exchange rates between most European currencies and the lira, corresponding to the "correct" cross rates with the dollar, undervalued the lira. This is, of course, only another way of saying that most European currencies were overvalued with respect to the dollar.

The Devaluation of September 1949

When the devaluation of the £ sterling was finally announced on September 18th, the degree of devaluation was found to be unexpectedly high. Consequently the Italian authorities, who might have tried to hold the 575 rate for the dollar if the £ had been devalued to say 3.20 instead of 2.80, decided that some adjustment of the lira-dollar rate had to be made.

The legal free market rate for the dollar, after being allowed to go as high as 637, gradually dropped back, until it reached 625 around the middle of October. The UIC now fixes its buying rate each *day* on the basis of the average of the closing rates on the free markets of Rome and Milan on the previous day (and similarly for the Swiss franc). The UIC's buying rate for the £, which

[1] Bresciani-Turroni, "The Problem of Cross Rates of Exchange," *Banco di Roma*, Review of the Economic Conditions of Italy, May 1948, pp. 153-4.

continues to be tied to its buying rate for the dollar and the official sterling-dollar parity, has accordingly varied between 1,782 and 1,750. At the time of writing it looks as though the authorities may have decided to hold the rate for the dollar at the 625 level. This rate represents a devaluation of the lira with respect to the dollar of approximately 9 per cent (as compared with a 30 per cent devaluation of the £ with respect to the dollar) and an appreciation of the lira with respect to the £ of approximately 21 per cent.

From a statement made by the Minister of the Treasury (Signor Pella) before the Chamber on September 30th, 1949, it appears that one of the considerations influencing the Italian authorities in determining the degree of adjustment in the exchange rates for the lira is the expectation that a 10 per cent rise in prices may take place in the United Kingdom, and that in that event Italian exporters will be obtaining approximately the same lira prices for goods exported to the United Kingdom as they did in the fall of 1948, just before the lira rate for the £ was tied to the dollar cross rate. Evidently it is hoped that if the purchasing power relationship which existed at that time is approximately reëstablished, the further accumulation of sterling balances will be arrested.

For some months past tentative negotiations have been taking place between Italy, France and Benelux with a view to creating an "area" on the Continent within which the currencies of the three countries would be freely transferable. These negotiations, which were temporarily interrupted by the French government crisis, received a new impetus from the speech of Mr. Paul Hoffman (the Economic Cooperation Administrator) at the end of October calling for an "integration" of European economies. If these negotiations succeed, they will establish on the Continent a "Transferable Account Group" similar to that established by the British Treasury for the sterling area and certain other countries. The success of such a scheme, once it is put into operation, will depend on whether the adjustments in the exchange rate structure which took place in September are sufficient to bring the balance of payments of each participating country with the rest of the group nearly enough into equilibrium, so that none of the countries has a surplus on current account with the rest of the group greater than the amount of balances it is willing to hold with the latter.

TABLE XI

Rates of Exchange for the Dollar and the £ Sterling

(Monthly averages)

		Dollar				Sterling			
		Legal free rate[1]	*Official rate*[2]	*Middle rate*	*Black market rate*	*Legal free rate*[1]	*Official rate*[2]	*Middle rate*	*Black market rate*
1946	May	364	225	294	333	1,446	907.3	1,177	920
	June	377	"	301	366	1,593	"	1,250	1,057
	July	478	"	351	401	1,864	"	1,386	1,222
	Aug.	505	"	365	484	1,847	"	1,377	1,369
	Sept.	596	"	410	530	1,965	"	1,436	1,464
	Oct.	600	"	412	523	1,966	"	1,437	1,426
	Nov.	568	"	396	611	1,653	"	1,280	1,664
	Dec.	568	"	396	683	1,522	"	1,215	1,824
1947	Jan.	528	"	376	607	1,529	"	1,218	1,689
	Feb.	532	"	378	590	1,704	"	1,306	1,741
	Mar.	605	"	415	644	1,974	"	1,441	1,818
	April	697	"	461	722	2,708	"	1,808	2,046
	May	906	"	565	801	3,576	"	2,242	2,315
	June	841	"	533	737	3,328	"	2,118	2,141
	July	775	"	500	662	2,919	"	1,913	1,954
	Aug.	721	350	535	637	2,479	1,411.3	1,945	1,804
	Sept.	667	"	508	665	2,264	"	1,838	1,699
	Oct.	618	"	484	645	2,194	"	1,803	1,608
	Nov.	603	589[3]	476	584	1,984	1,961[3]	1,698	1,453
	Dec.	575	603	589	582	1,637	1,984	1,812	1,416
1948	Jan.	573	576	574	592	1,755	1,637	1,696	1,425
	Feb.	573	573	573	612	1,837	1,756	1,797	1,501
	Mar.	574	573	573	663	1,839	1,838	1,839	1,533
	April	574	574	574	618	1,851	1,840	1,846	1,484
	May	575	575	575	587	1,950	1,851	1,901	1,572
	June	"	"	"	582	1,963	1,947	1,955	1,619
	July	"	"	"	583	1,935	1,963	1,949	1,648
	Aug.	"	"	"	582	1,937	1,936	1,937	1,640
	Sept.	"	"	"	615	1,944	1,937	1,941	1,666
	Oct.	"	"	"	656	2,037	1,944	1,991	1,726
	Nov.	"	"	"	642	2,187	2,033	2,113	1,813
	Dec.	"	"	"	656		2,317		1,937
1949	Jan.	"	"	"	665		"		1,996
	Feb.	"	"	"	681		"		2,031
	Mar.	"	"	"	662		"		2,069
	April	"	"	"	626		"		2,023
	May	"	"	"	624		"		1,966
	June	"	"	"	611		"		1,840
	July	"	"	"	607		"		1,754
	Aug.	"	"	"	606		"		1,696
	Sept.[4]	631.8	632.0	631.9	690		1,769.5		1,857
	Oct.	628.1	628.1	628.1	676		1,758.6		1,751

[1] *Cambio di esportazione*: the rate at which exporters sold 50 per cent of their foreign exchange on the *piazza di Roma*.

[2] Rate paid by UIC.

[3] Last three days of November.

[4] Sept. 19th-30th.

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