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PRINCETON STUDIES IN INTERNATIONAL FINANCE, NO. 1

Monetary and
Foreign Exchange Policy
in Italy

Friedrich A. and Vera C. Lutz

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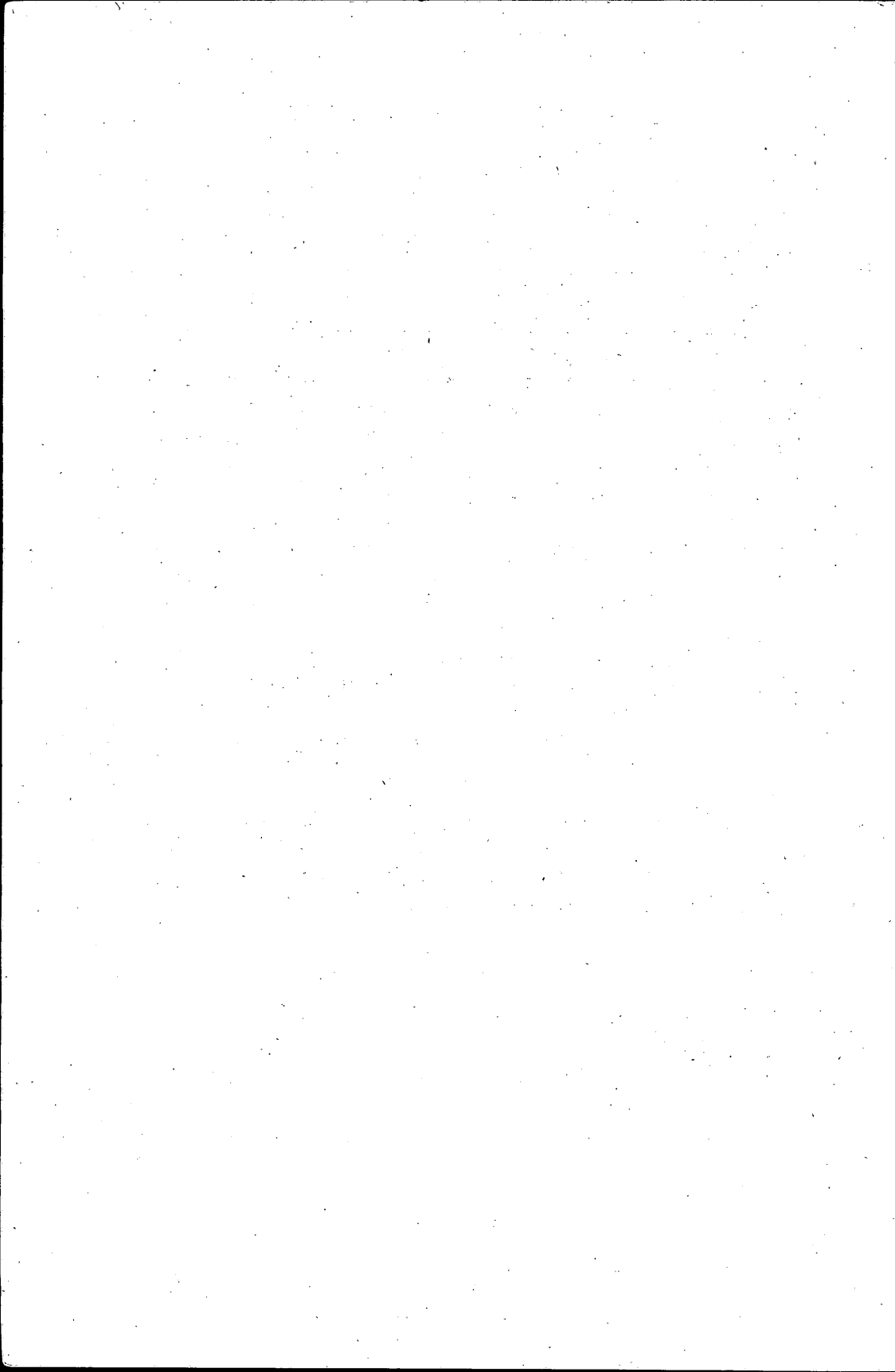
The International Finance Section will continue to publish from time to time papers in the ESSAYS IN INTERNATIONAL FINANCE series which was begun in 1943 under the direction of the late Professor Frank D. Graham. As in the past, these publications will be confined in length, content, and style to scholarly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

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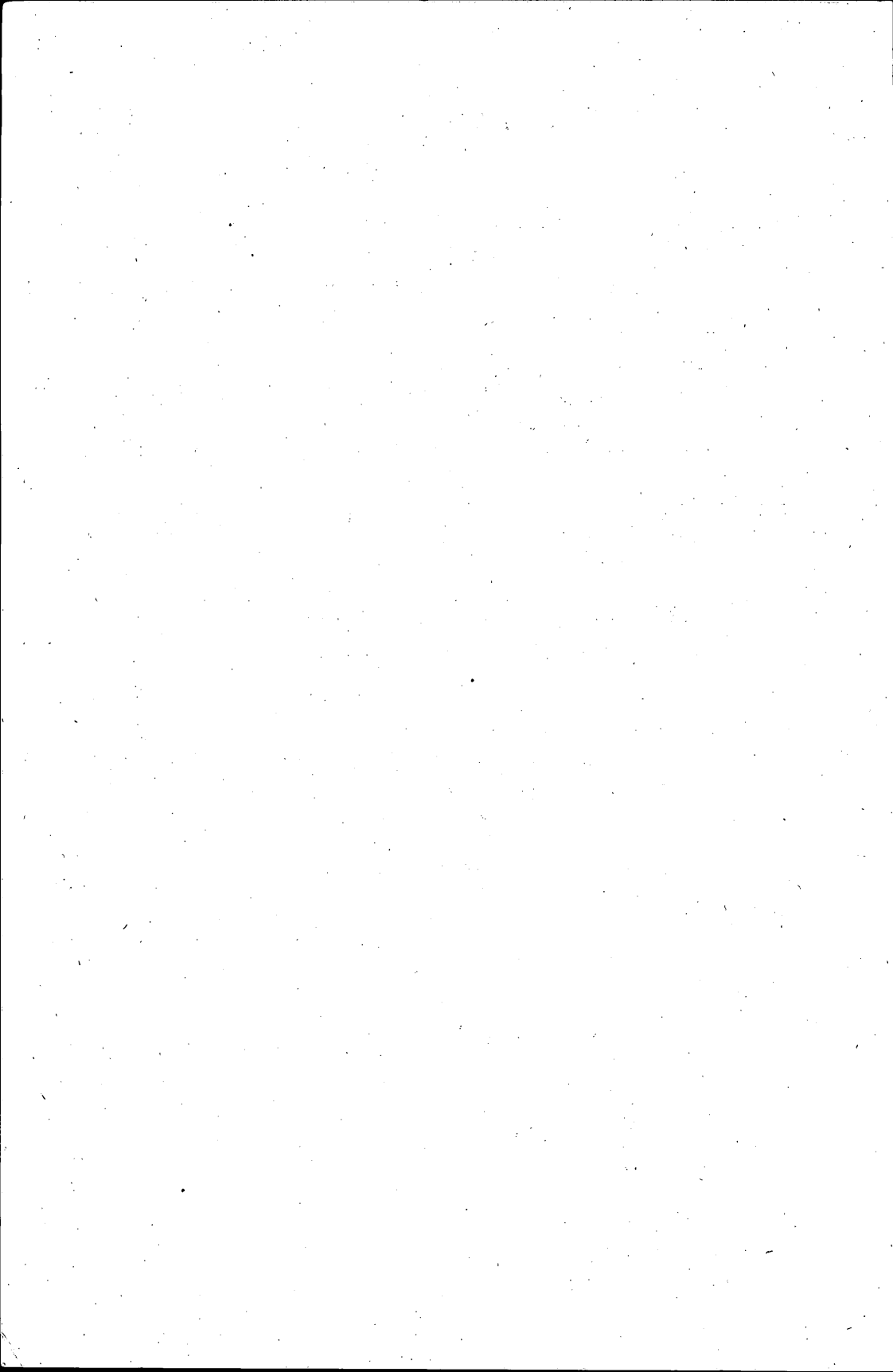
GARDNER PATTERSON, *Director*
International Finance Section

Princeton University
January 1950



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I. INTRODUCTION¹

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 reestablished, 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 level¹ 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

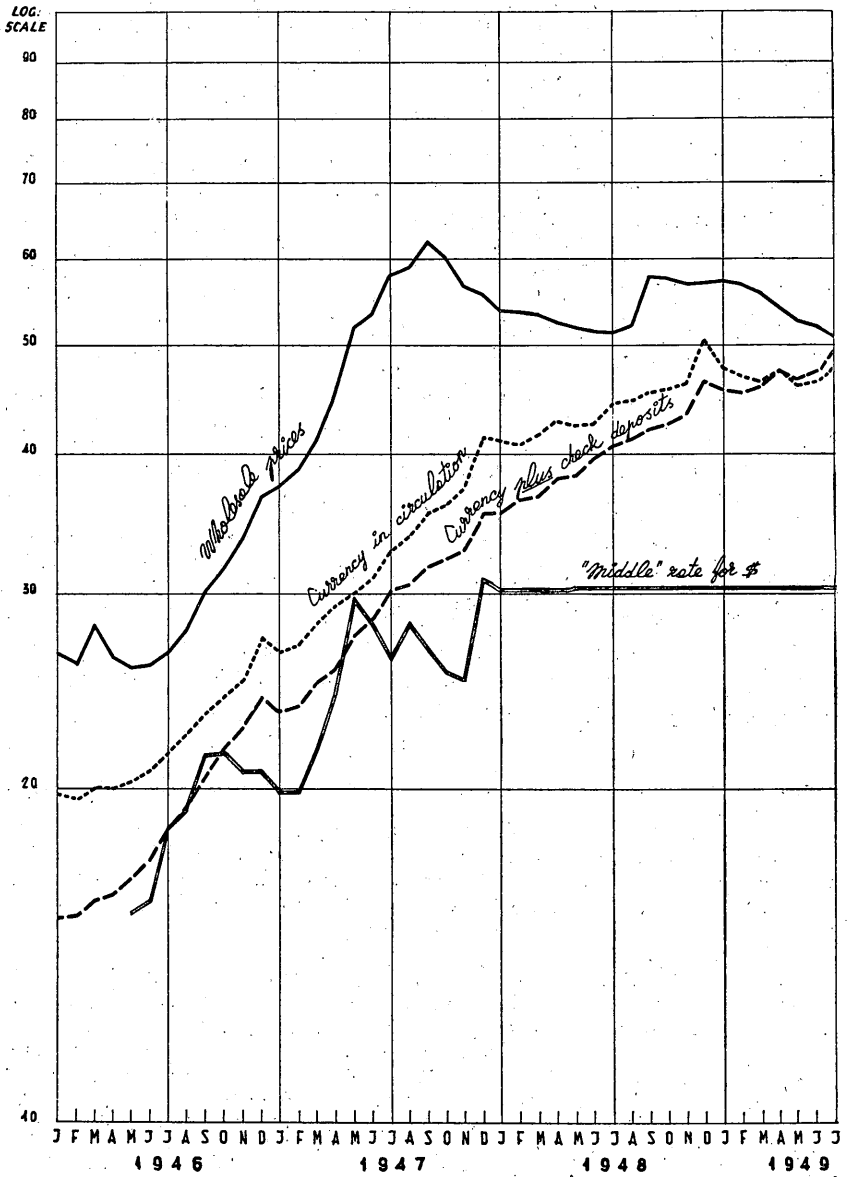


TABLE I
SELECTED ECONOMIC DATA FOR ITALY

Year and month	Currency in circulation ¹ (Billions of lire)	Volume of money ¹	Wholesale price index	Cost of living index	Wage index	Index of production (1947=100)
<i>1938</i>						
(average)	22	40	100	100	100	
<i>1946</i>						
June	458	695	2,593	2,627	1,654	
September	511	830	3,011	2,810	1,842	
December	600	979	3,677	3,416	2,758	
		(955) ²				
<i>1947</i>						
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
<i>1948</i>						
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
<i>1949</i>						
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 valutarî*).

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 CIRCULATION¹
(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	} +16.6
"Wheat bills"	+64.7	+30.3	+2	
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)

End of—	Credit to government	Credit to private business and local authorities	Check deposits	Savings deposits	Total deposits
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	485.4	528.5	953.9
		(783.3) ²			
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

TABLE IV
BUDGET DEFICITS OF THE ITALIAN GOVERNMENT¹
(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.

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

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:

	<i>Estimates</i>	<i>Actual Results</i>
	<i>(Billions of lire)</i>	
Expenditures	341	921
Revenues	148	352
Deficit	—193	—569

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