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1. Policy Instruments

CENTRAL-BANK POLICY

The Bank of Italy, the country's central bank, is formally among the least independent of those studied in its conduct of monetary policy. All important policy decisions are made by an Interministerial Committee, chaired by the Minister of the Treasury and including other Ministers and the Governor of the Bank of Italy. But the execution of the Committee's decisions in monetary matters is then left to the Bank. And, in fact, the Governor of the Bank is reputed to have a major impact on the direction of policy, in part since, as will be noted shortly, monetary policy in Italy is conducted essentially by day-to-day decisions, made primarily by the Bank.

The Bank of Italy makes very little use of the three "classical" instruments of monetary policy—the discount rate, minimum-reserve requirements, and open-market operations. The discount rate was reduced a few times during the period from the end of World War II to 1950. From early 1950 to 1966, however, the rate was changed only once: in June 1958 it was lowered from 4 to 3.5 per cent. Minimum-reserve ratios were introduced in 1947 at the level of 25 per cent; since then, the rate has been changed only once—in early 1962, it was lowered to 22.5 per cent. The Bank of Italy rarely conducts open-market operations in the usual sense. As will be noted shortly, however, a few other instruments used by the Bank and the Treasury are similar to open-market operations, but these, too, are used only sporadically. The Bank of Italy thus relies mostly on instruments such as those described below, which most other central banks would consider subsidiary.

Bank Lending to Commercial Banks. As has just been noted, the Bank of Italy did not try to use the discount rate—which remained

practically stable throughout—to affect the amount of lending to commercial banks. But the Bank is not committed to rediscount bills for the commercial banks or to make advances to them. This is left to the Bank's discretion, and it has varied the amount of lending to commercial banks according to its over-all view of monetary policy.

The amount of rediscounting done by the Bank of Italy (excluding "storage" or "crop" bills, which will be mentioned later) is usually quite small; advances against securities are larger, but still not very substantial. Total lending by the Bank to commercial banks is thus small, but variations have on occasion been large in relation to the total and may have played at least some role.

Control of Commercial-Bank Lending. The Bank of Italy's approval is required for any single loan exceeding a given proportion of a commercial bank's capital. The Bank thus maintains a certain measure of direct control over the amount of lending by commercial banks to their customers. This apparently affects mainly the smaller banks whose limited capital often makes them subject to the *fidi eccedenti* provision. It is chiefly the larger institutions, on the other hand, that are subject to the "moral suasion" exercised by the Governor of the Bank of Italy on the commercial banks, and the two approaches thus tend to complement each other. The Bank of Italy is reported to use these means on occasion to influence the development of commercial-bank lending, though in neither case can one measure the impact.

Foreign-Exchange Transactions. Since the late 1950's (and probably, to a small extent, even earlier), the Bank of Italy has used foreign-exchange transactions with the commercial banks as an instrument of monetary policy. In their effect on the banking system's liquidity, these transactions are the equivalent of open-market operations, the difference being only that the transaction is in foreign exchange rather than government securities or other domestic paper. As a means of restricting monetary expansion, the Bank of Italy offers commercial banks favorable terms for the purchase of foreign-exchange spot from the Bank against its commitment to a forward purchase from the commercial bank. The latter can then use the foreign exchange so acquired for lending in the local market or in foreign markets, for increasing its foreign-exchange holdings, or for reducing the amount of its short-term borrowings abroad. Its domestic liquid resources will decline by the amount of foreign exchange purchased—which is, in turn, equal to the improvement in its net foreign-exchange position. This may be

reinforced by a direct restriction of the amount of commercial-bank borrowing from abroad.

BUDGETARY POLICY AND THE TREASURY'S FINANCIAL ACTIVITY

Besides having a larger influence, at least formally, on the central bank's conduct of monetary policy than in most other countries, the Treasury in Italy also exerts an extensive monetary impact by its own financial transactions.

The cash budget in Italy has shown a deficit almost without interruption during the period. This deficit is financed primarily by sales of government securities to all other domestic sectors—the public, commercial banks, and the Bank of Italy—and by postal savings.

Commercial banks buy two types of Treasury paper, the short-term Treasury bill and longer-term government securities. Treasury bills are held by commercial banks as part of their reserves, since the minimum reserve regulations specify either Treasury bills or deposits at the Bank of Italy as reserves; a generally smaller amount is held as "free" Treasury bills, those beyond the amount calculated as part of their reserves.

Commercial banks, along with the public, also buy longer-term government securities, which the Treasury puts on the market mostly at the beginning of the year, when banks are as a rule particularly liquid. The placement of these securities may be regarded as having, in part, the function of an open-market operation designed to eliminate excess liquidity, since in determining the amount to be sold, the Treasury is said to have weighed, on occasion, the liquidity position of the commercial banks against what the Treasury (and the Bank of Italy, which technically works as the Treasury's agent) would like it to be.

The Treasury borrows a significant amount from the Bank of Italy, and its outstanding total has been growing over the long run. It consists of several items: One is current advances, which may reach a legal maximum of 15 per cent of the budget's current expenditures. Another is the "extraordinary" advances that were created during the war and the early postwar years. The outstanding amount did not change throughout the 1950's, but from 1960 on, the government has been repaying these advances gradually. A third is advances in foreign exchange, which, technically, are received from the Foreign Exchange Office, but essentially are a form of net borrowing from the Bank of Italy.

The Bank of Italy also rediscounts "crop bills." These are issued by governmental storage agencies, which supposedly buy the crops, mainly wheat, at harvest time for storage. This is a form of government subsidy, since very often the eventual sale price is below what the storage agencies pay for the crop. While the crop bills are issued to commercial banks, which technically finance the transaction, the bills are eligible for automatic rediscounting at the Bank of Italy and as a rule are rediscounted promptly. In effect the crop bills are a means of governmental borrowing from the Bank of Italy, in which commercial banks play only an intermediary role.

Finally, the Bank of Italy buys Treasury bills as a counterpart to the deposits which commercial banks hold at the Bank as part of their legal reserves, although the two are not exactly equal—the amount of Treasury bills is normally smaller than the amount of commercial-bank deposits. The Bank of Italy may also hold Treasury bills in larger amounts and without any relationship to reserve requirements; there are no legal restrictions on the amount of Treasury bills which it may buy.

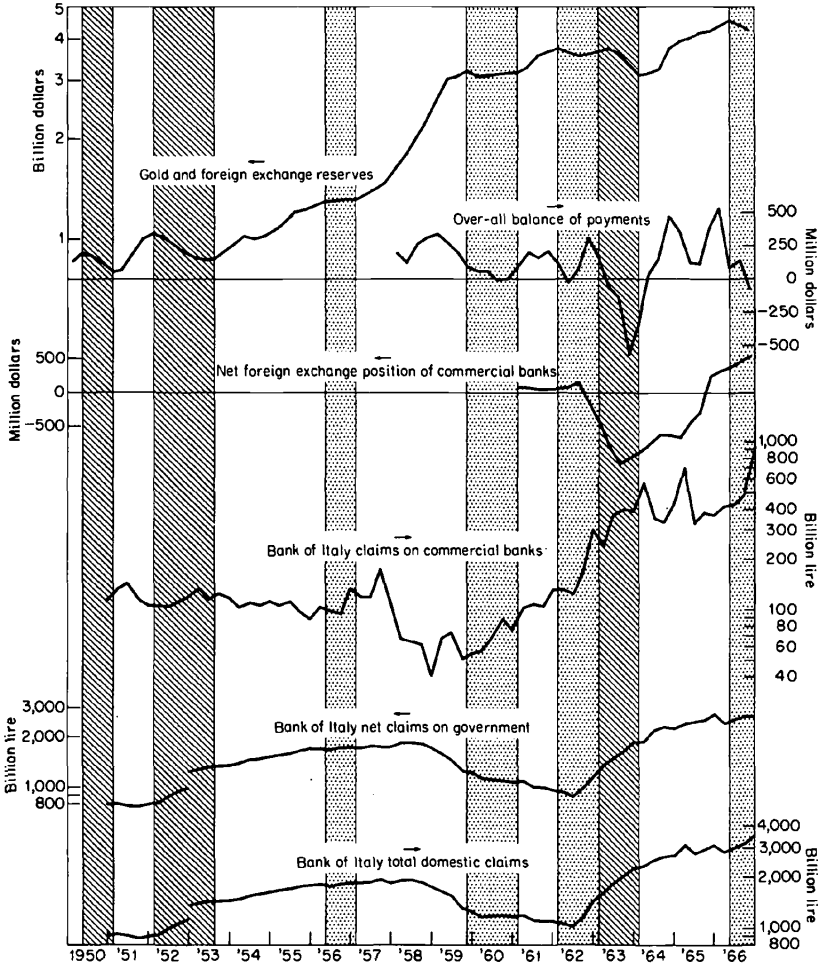
Variations in the amount of Treasury bills held by the Bank of Italy may represent merely a substitution of no real significance for monetary aggregates. Commercial banks, it should be recalled, may hold their reserves either as deposits at the Bank of Italy or in the form of Treasury bills. If they decide to switch from deposits to Treasury bills, this will induce the Bank of Italy to reduce the amount of Treasury bills which it holds as a counterpart to commercial bank deposits (which have now declined). But the reduction does not represent, in this case, any change either in governmental borrowing or in the size of commercial-bank liquidity. It merely indicates a transfer of the holding of Treasury bills from the central bank to commercial banks, and its impact is restricted to its effect on their profits. Such a process indeed took place in 1959 and 1960, when all the Treasury bills held by the Bank of Italy as counterpart for commercial-bank reserves disappeared.

2. Statistical Analysis

Chart 7-1 presents the policy variables that appear, from the foregoing discussion, to be most relevant for balance-of-payments adjustment,

CHART 7-1

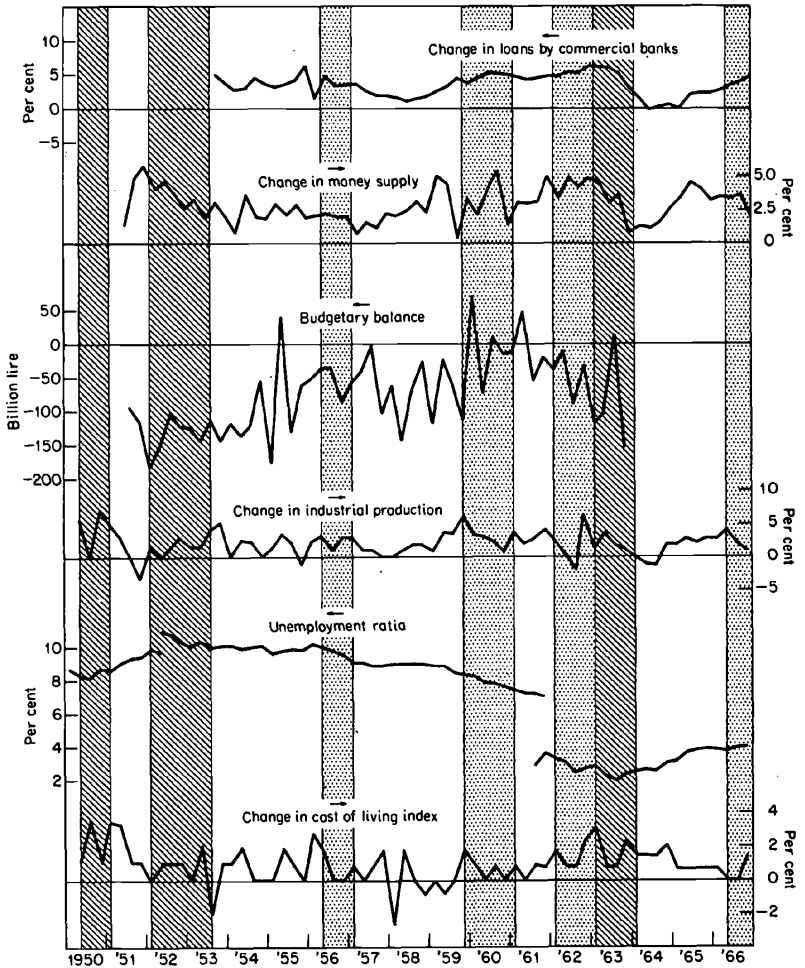
ITALY: TIME SERIES OF SELECTED VARIABLES



along with indicators of balance-of-payments disturbances¹ and other potential target variables. Table 7-1 provides a summary description of the behavior of policy variables during subperiods delineated by balance-of-payments developments.

¹ Since balance-of-payments movements reveal an obvious seasonal pattern, data on external reserves and the over-all balance of payments had to be seasonally adjusted.

CHART 7-1 (Concluded)



NOTE: Diagonal-line areas represent period of downward imbalances; gray areas represent stability; white areas represent upward imbalances.

It was usually not difficult to determine subperiods, since movements of external reserves show a pattern which other evidence does not contradict. For one period, however, 1962-1963, the evidence is mixed; since this episode is of particular importance, as will be pointed out later, the determination of turning points within it merits some discussion. For the first quarter of 1962, all the relevant (deseasonalized) data

TABLE 7-1
ITALY: MOVEMENTS OF POLICY VARIABLES DURING SUBPERIODS OF IMBALANCES

Subperiod	External Reserve	Bank-of-Italy Lending to Banks	Net Foreign Exchange Position of Commercial Banks	Bank-of-Italy Lending to Government	Bank-of-Italy Total Domestic Claims	Change in Commercial Bank Credit (quarterly average, per cent)	Change in Money Supply (quarterly average, per cent)	Budgetary Balance (quarterly average, in billions of lire)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
II 1950 - I 1951	fall	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
I 1951 - I 1952	rise	* stable	n.a.	* stable	* stable	n.a.	+4.1	-130
I 1952 - III 1953	fall	* stable	n.a.	- rises	- rise	n.a.	(+) +3.2	(*) -126
III 1953 - II 1956	rise	* stable	n.a.	+ rises	+ rise	+4.1	(-) +2.3	(-) -87
II 1956 - I 1957	stable	rises	n.a.	stable	stable	+3.5	+1.6	-59
I 1957 - IV 1959	rise	- falls	n.a.	- falls	- fall	(-)	(+) +2.5	(*) -68
IV 1959 - I 1961	stable	rises	rises	falls	fall	+4.9	+3.3	-3
I 1961 - I 1962	rise	+ rises	* stable	- falls	- fall	(*) +4.6	(+) +3.9	(*) -15
I 1962 - I 1963	stable	rises	falls	rises	rise	+5.7	+4.7	-62
I 1963 - I 1964	fall	- rises	- falls	- rises	- rise	(+) +3.9	(+) +2.2	(-) -80
I 1964 - II 1966	rise	n.a.	- rises	+ rises	n.a.	(-) +1.1	(+) +2.9	n.a.

NOTE: For explanation of symbols, see Chapter 3, explanatory note. n.a. = not available.

point clearly to a continuation of the balance-of-payments surpluses of 1961. In the second quarter, a small deficit occurred, and some analyses give mid-1962 as the turning point from which to date the start of the large deficit which ran through 1963. Later in 1962, however, a substantial surplus reappeared. For the year from the second quarter of 1962 to the first quarter of 1963, taken as an aggregate, the following phenomena may be noted: Foreign-exchange reserves remained about stable.² The balance of payments (on the "official settlements" definition explained in Chapter 2, Section 6) shows a considerable over-all surplus of about \$500 million. All this surplus, however, may be explained by a deterioration of the net foreign-exchange position of commercial banks (that is, by commercial-bank short-term borrowing abroad), which amounted to some \$600 million and which was most probably not regarded, by the government or by others, as a permanent feature or a "normal" source of receipts from abroad. It is thus likely that this was a period of neither a deficit nor a surplus but of approximate over-all balance.³ In the second quarter of 1963, on the other hand, a change is obvious; external reserves are stable, but balance-of-payments data show a deficit in spite of a further deterioration in the net foreign-exchange position of commercial banks. This quarter may therefore be regarded as the beginning of the downward movement which was intensified during the next three quarters. The imbalance came to an end in the second quarter of 1964, in which external reserves remained about stable, and a slight over-all surplus appeared in the balance of payments despite a reduction of commercial-bank borrowing from abroad.

The subperiods are defined in Table 7-1, where the direction of imbalances is indicated in column 1. Changes in the Bank of Italy's lending to commercial banks are noted in column 2. As is readily apparent from Chart 7-1, this variable was rather stable and quite small until the beginning of 1957. During those earlier years, this variable seems to have been neither responsive to balance-of-payments developments nor very significant for any other purpose. In later years, the

² This is based on data from *International Financial Statistics*, the source of foreign-exchange reserve statistics used most often in this study. However, data from the *Bolletino della Banca D'Italia* show a substantial increase, and seem to be more consistent with balance-of-payments estimates.

³ When the net foreign-exchange position of commercial banks is added to official reserves, a substantial decline of the combined magnitude appears during the year under consideration; this may be judged from Chart 7-1. But, once more, if the figures on reserves taken from *International Financial Statistics* are replaced by those reported in the *Bolletino*, most of this decline would disappear.

Bank of Italy's lending to commercial banks shows a tendency, although not a very consistent one, to move in a direction opposite to balance-of-payments developments, that is, in a disadjusting manner. It also assumed, toward the end of the period, a more substantial size. An examination of long periods reinforces the impression that its movements were opposite in direction to those of external reserves. From mid-1953 onward, two longer-term periods may be distinguished: until the end of 1959, a very strong rising trend in external reserves was maintained, while from then on the upward trend, although still present, was only slight. The Bank of Italy's lending to commercial banks was small and falling slightly during the first of these periods, whereas in the second it manifested a strong upward trend. It should be noted that in the subperiod from early 1963 to early 1964—the only episode of an actual, substantial fall of reserves since 1953—lending to commercial banks kept growing.

Column 3 of Table 7-1 relates to the net foreign-exchange position of commercial banks. Data for this variable are not available for years prior to 1959, a period in which the variable was apparently not very significant. Since then, this variable, too, generally moves in a disadjusting direction, but not very consistently. The subperiod of downward imbalance from 1 1963 to 1 1964 again deserves particular attention. In the first two quarters of this subperiod, the variable in question continued an earlier downward movement. This movement, in a direction opposite to the movement of external reserves, is in line with the general pattern of the net foreign-exchange position of commercial banks, and may be explained by the banks' desire to offset, by borrowing abroad, the effect of balance-of-payments developments on their liquid reserves. In the last two quarters of the subperiod, on the other hand, the variable rises, although not to the full extent of its decline in the first two quarters. This is explained by deliberate measures taken by the Bank of Italy to restrict borrowing abroad and to encourage the banks to hold foreign exchange. This episode, during the period of downward imbalance, is the only major occasion when the variable in question was manipulated in a direction consistent with balance-of-payments adjustment.

In column 4 movements of the Bank of Italy's net lending to the government are described.⁴ Since these are found to be very similar, in

⁴ In addition to a series of the government's net indebtedness to the central bank defined in a way similar to that applied in other cases, two other series have been constructed. One excludes the Treasury bills held by the Bank of Italy as counterpart to commercial-bank deposits at the Bank. Going in the opposite

direction of movement, whether or not Treasury bills obtained as a "counterpart" to commercial-bank deposits are included, only the former alternative is represented in Chart 7-1. It appears that no general, clear association of movements of this variable with balance-of-payments movements may be established. As may be seen from Chart 7-1, the amount of this lending tended to rise, slightly but consistently, from 1951 to mid-1958; to fall from then to mid-1962; and to rise quite strongly from that point to the end of the period. Each of these three periods included episodes of surpluses, deficits and stability of the balance of payments, without any apparent effect of these fluctuations on the trend of development of the debt. From the evidence of column 4, some tendency of the variables in question to move in a disadjusting direction may be detected; but the evidence is not very strong.

When Treasury bills held by commercial banks are added to the government's debt to the Bank of Italy (a series not represented in Chart 7-1), the trends of developments are found to be slightly different; the variable seems now to be stable, rather than to fall, between 1958 and 1962. But the conclusion that movements of this variable appear to be generally unrelated to balance-of-payments developments, or probably tend only slightly to move in a disadjusting direction, remains valid.

This is also largely true of the Bank of Italy's total domestic assets, as may be seen from column 5. This variable is dominated by the Bank's lending to the government and moves in much the same way. The inclusion of the Bank's lending to commercial banks—which, as has been noted, tends to move in a disadjusting direction—matters little for the movements of the Bank's total assets. The latter reveal, at best, a slight tendency to move in a direction opposite to movements of the balance of payments.

The rate of expansion of commercial-bank lending to the public is given in column 6. There and in Chart 7-1, it may be seen that, while the rate fluctuated during the period surveyed, these fluctuations cannot be associated in any consistent way with those of the balance of

direction, a series is also constructed which includes *all* Treasury bills, whether held by the Bank of Italy or by the commercial banks. While the fraction which is held by commercial banks does not, of course, form a part of the government's indebtedness to the Bank of Italy, it has an effect identical with central-bank lending in its impact upon commercial-bank reserves. As an indication of the influence of government finance on commercial-bank reserves, the observation of this combined magnitude may be helpful.

payments. Only during the downward disturbance from 1963 to 1964 did the movement of the rate, which declined considerably, conform closely to the requirements of balance-of-payments adjustment. The rate remained very low, however, after this episode, apparently not as a result of any policy decision but due to a lack of demand for bank credit.

On the other hand, as may be seen from column 7 of Table 7-1 and from Chart 7-1, money supply did move in an adjusting direction as required by balance-of-payments developments. The association is not perfect, but its existence seems certain, and it is consistent over the period as a whole. Every deterioration of the balance-of-payments position is accompanied by a clear tendency of the rate of expansion of money supply to fall; and with almost every upward turning of the country's external reserves, an upward movement appears also in the rate of expansion of money supply.

Finally, none of the budgetary variables—revenues, expenditures, or the budgetary balance—appear to be associated with the balance of payments. For the budgetary balance this may be seen from Chart 7-1, and from column 8 of Table 7-1. The budgetary deficit is rather stable during 1951–54; it then declines gradually, to the point of complete disappearance, between 1955 and 1960, and rises again between 1961 and 1963, the latest year for which data on this variable are available. None of these trends can be explained by balance-of-payments developments.

The general lack of association between most policy variables and balance-of-payments tendencies probably cannot be explained by assuming that these policy instruments were used to achieve some other major economic targets—price stability, high employment, or a high rate of growth. The price level appears not to be increasing throughout most of the time, at least from 1951 to 1961; this holds true both for the cost-of-living index, which is shown in Chart 7-1, and even more so for the index of wholesale prices, which actually declined during these years. The unemployment ratio appears to be rather high, declining gradually but only slightly, until mid-1959, and then somewhat more rapidly until mid-1963. Here, too, none of these developments seem to have any consistent effect on movements of policy variables. From mid-1963 to the end of 1965 unemployment was rising—and the discussion will shortly return to this experience. The index of industrial production, plotted in Chart 7-1, appears to have been rising at a fairly steady and high rate. Significant dips in the rate of increase of produc-

tion may be observed only for the periods from mid-1951 to mid-1952, from mid-1957 to mid-1958, and from mid-1963 to late 1964. For the first of these periods information about most policy variables is missing; the second appears to leave no impact on policy variables; and the third will now, again, be discussed separately.

The period extending from early 1963 to mid-1964 seems, from the foregoing review, to be an episode of major interest for an examination of the conduct of policy in Italy. During that episode all trend lines were broken: the balance of payments turned from surplus to deficit; prices, stable at most other times, rose considerably; unemployment changed its course and started climbing; and the rate of expansion of industrial production, stable and high most of the time, not only declined but even became negative for a brief period. These are, of course, developments of a contradictory nature, with opposite claims on the use of policy instruments: the first two targets, balance-of-payments equilibrium and price stability, would call for restrictive policies; while the other two—high employment and high growth—would call for expansionary measures. The timing of these conflicting developments did not coincide precisely, but at least for part of this period, during late 1963 and early 1964, the contradiction is clear. It may be interesting to note, therefore, in which directions the different policy variables moved in response to these conflicting demands.

On the whole, financial policy seems to have been restrictive during this episode, as would be required for balance-of-payments equilibrium and price stability. But the pattern is far from clear-cut. As the major restrictive movement, the drop in the rate of expansion of money supply may be cited. This would have been the outcome of the fall in external reserves alone, but it was also helped by a very substantial decline of the rate of expansion of credit. The latter, again, would have resulted merely from the fall in commercial-bank reserves due to the fall of the country's external reserves; but it was also affected by other policy variables—and here the evidence is mixed. On the one hand, the net foreign-exchange position of commercial banks improved significantly, most probably due to the Bank of Italy's specific actions; this is a restrictive measure, which reduces banks' reserves and lending capacity. On the other hand, lending by the Bank of Italy to commercial banks increased. Similarly, lending by the Bank to the government, which affects both money supply directly and commercial-bank reserves, also expanded. From this evidence, it is not clear at all whether the Bank of Italy (and the government) tried to reinforce the restric-

tive impact of the balance-of-payments deficit on money and credit supply, or to neutralize it. It is conceivable that the conflicting demands of the various targets pulled monetary policy in both directions and led to inconsistencies. Unfortunately, data for the budgetary variables are missing for part of this crucial period. From the available evidence, the budgetary balance appears to have tended during this episode toward increasing deficits—an expansionary measure. This may be, again, part of a general inconsistency. But it may also be due to a decision to use monetary measures in a restrictive way, to serve the needs of balance-of-payments and price stability, and, at the same time, to use budgetary policy in the opposite way, to combat unemployment and the slack in production. This would also explain the increase in the Bank of Italy's lending to the government. But the nature and duration of the evidence would make such an explanation, at best, speculative.

3. Summary and Interpretation

Italy appears to be a country in which monetary policy was subject, to a larger extent than in most other countries, to automatic mechanisms. The reserve ratio for commercial banks and the discount rate were maintained virtually unchanged throughout the period. Other policy variables employed by the monetary authorities, though not stable, do not appear to have been used in accordance with some overriding rules—either in order to adjust the balance of payments or to serve other major policy targets. As a result, money supply (that is, its rate of expansion) was, by and large, allowed to fluctuate in the same direction as foreign-exchange reserves. The impact of the latter on the former tended to be neutralized, to some extent, by an offsetting recourse of commercial banks to borrowing from the central bank when reserves fell, and by the redemption of the debt when reserves rose. But this tendency was much less consistent, and much less important, than in most other countries. Another partly offsetting factor was the tendency of commercial banks to increase their short-term borrowing from abroad as a substitute for the liquidity acquired by external reserves, when the latter failed to rise. This was quantitatively more important than the former factor; but it, too, was not very consistent, and played a part only from the late 1950's.

From mid-1953 to the end of 1959, the balance of payments was

consistently in surplus, often a very substantial one. Evidently, the automatic impact of external reserves on the money supply was not sufficient to lead to a full adjustment during this period. Had this adjustment been desired, a reinforcing of the automatic mechanism would have been called for. The lack of a deliberate policy in that direction would thus indicate that the accumulation of reserves was considered a desirable feature rather than a disturbance calling for correction.

This impression gains support from the single major episode in which external reserves declined—namely, the period from early 1963 to early 1964. Although the level of reserves was by that time very high in relation to earlier years and to other relevant economic magnitudes (such as the level of imports, or the GNP), deliberate policy measures were taken this time in an adjusting direction. This was done by a reduction, directed by the Bank of Italy, of the commercial banks' foreign indebtedness and of the rate of increase in their credit to the public. During at least the greater part of this episode, the restrictive policy measures were taken in spite of a slack in domestic activity. It would thus seem that, in a time of deficit, the requirements for balance-of-payments adjustment were given priority over domestic targets.

Other analyses of the Italian economy indicate that budgetary policy was considered a major tool in the service of long-term growth, used to increase the proportion of saving and investment and to affect the direction of investment. But this policy does not appear, from available data, to react to short-term fluctuations in the rate of expansion. The absence of the use of budgetary policy for balance-of-payments adjustment thus does not seem to be due to the appropriation of this policy instrument for the control of domestic activity. The only episode for which such an interpretation would seem plausible is that of 1963, when the budgetary deficit increased, while monetary policy was restrictive. This may have been due to the wish to use budgetary policy to combat the slack in economic activity, while monetary policy was assigned the role of adjusting the balance-of-payments deficit.

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