The Transformation of the Financial Markets

1. Financial innovation, monetary policy and the financial markets

The money markets that had developed in Italy, albeit discontinuously and on a small scale, quickly adapted to the changes in the liquidity situation of the banking system, allowing the banks to operate with a lower level of liquidity than before in the event of a monetary squeeze.[1] With a series of innovations already implemented in the more advanced financial centres abroad it had broadened the medium and long-term money market and overcome the shortage of savings at long term by issuing variable rate instruments, as the placement of large quantities of securities with the public had indirectly had a restrictive effect on household consumption.

Monetary policy was also affected by the changes in the financial markets,[2] which involved innovations in the instruments used to raise capital and the techniques used to share and transfer interest-rate and exchange-rate risk as well as changes in the size of the markets and the information flows handled in real time by market participants.

With the end of the high and variable inflation that had afflicted the Italian economy until the mid-1980s, financial innovation and capital mobility began to have an increasingly large impact on monetary policy. Although the new situation had obvious benefits, there were also several factors that contributed to increasing uncertainty, such as the greater complexity, interdependence and fragility of the system produced by financial innovation.[3] By generating considerable instability in the behaviour of demand, innovation regularly forced the monetary authorities to redefine the monetary aggregates they tracked. At the same time, the direct sale of securities on the capital market, which tended to remove banks from the process of financial intermediation and push them away from traditional lending towards off-balance-sheet operations, weakened the link between monetary and credit flows and the level of economic activity. The globalization of markets led to greater capital mobility between different currencies and different banking systems, which in turn increased the potential instability of the relationships between monetary aggregates and demand. In short, financial innovation had reduced the role of credit as a transmission channel for monetary policy.

[1] See Section 8.

[2] Guido Carli, "Money markets - trends and challenges", *Review*, XXXVIII, 3 (September-December 1984), pp. 305 *et seq.*

[3] Mario Arcelli, "New monetary policy trends in the leading western countries", *Review*, XLI, 2 (May-August 1987), pp. 149 *et seq.*

As a result of greater international capital mobility the interest rate was no longer the only instrument of monetary policy. It was now joined by the exchange-rate, and exchange-rate expectations played a major role in capital movements between the different economies. Thus, "the potential size of such oscillations and their effect on economic activity and inflation often discourage monetary authorities from pursuing highly discretionary policies".[4] Exchange-rate variations also had an impact on productive sectors that exported or imported goods and in certain services such as tourism and international transportation. This made it all the more urgent for countries to coordinate their monetary policies.

2 Monetary policy and the balance of payments

The industrial countries and the EEC began to move towards greater monetary policy coordination after 1985, which marked their rejection of the US philosophy that the economy should not be subject to international management, arguing instead that each country should put its own house in order. In 1985 the approval of the Single European Act launched the preparations for the Single Market, which was to come into existence in 1992 and with it the liberalization of capital movements. Progress was also made in 1986-1987 at the meetings of the G5 countries and then the G7, which reiterated the need for closer economic cooperation and scheduled regular meetings to seek to remove any barriers to such cooperation that might arise.

The liberalization of foreign exchange in the EEC in 1990 also improved the outlook for integration and, as Mario Sarcinelli wrote, in a certain sense consolidated "expectations ...regarding the strengthening of the macroeconomic adjustment, already largely achieved by Italy's economy".[5] The year 1986 saw the end of the long cycle of disinflation, marked by a decline in the inflation rate from 22 per cent in the early 1980s to an average of 5.9 per cent in 1986 as a whole and 4.2 per cent in December of that year, and by the significant improvement in the trade balance, helped by the fall in the price of oil and the dollar and by keeping the borrowing requirement at its 1985 level. The long decline in fixed investment also came to a halt: "Investments in plant and machinery by industrial firms were high as a ratio of GDP, and indeed higher than those of their European competitors".[6] Productivity also rose considerably, partly owing to the massive use of electronics in production, which increased the competitiveness of Italian firms in international markets but reduced the demand for labour. In short, "the stepping up of productivity had made a significant contribution to the decline of inflation by reinforcing the effects of

[4] *Ibid.*, pp. 152 *et seq.*
[5] Mario Sarcinelli, "Toward Financial Integration in a European and International Context: Exchange Liberalization *Review,* XLI, 2 (May-August 1987), pp. 129 *et seq.*
[6] *Ibid.*, p. 130.

monetary policy and exchange rate management", while taking advantage of the fruits of more relaxed industrial relations.

The end of the inflationary crisis seemed near, at least at the macroeconomic level. It had not been an easy task. In his article, Sarcinelli traced the difficult efforts to curb inflation, analyzing the measures taken in more recent years, especially after 1984. These included the abolition of the requirement for foreign-currency financing of imports, the extension of the duration of foreign-currency accounts, the reduction of the non-interest-bearing deposit on investment abroad to 5 per cent and the restoration of the external convertibility of banknotes. This was followed in May 1987 by the complete elimination of the non-interest-bearing deposit, several months before having been eliminated under European law.

These measures were accompanied by the liberalization of numerous other procedural and administrative constraints, including an increase in the foreign currency travel allowance to OECD levels, the increase in the ceiling for transactions exempted from foreign-exchange formalities and the elimination of the requirement for advance approval of commercial transactions by authorized banks.[7]

The enactment of these measures, especially the latter, was not universally well-received. Criticism was strongest after the balance of payments on a settlements basis showed a deficit of 3,211 billion lire in May, compared with a surplus of 1,555 billion in the same month a year earlier. However, this criticism, some of which was advanced by former supporters of the measures, was rebutted by recalling how effective an engine for growth the trade liberalization of the 1950s and 1960s had been and how membership in the EMS had produced such benefits for both labour and business interests.[8]

3. European monetary and financial integration

The final goal of coordinating the monetary and financial policies of the Community countries was monetary union, although some did harbour doubts about the feasibility of the project. Antonio Fazio argued that there would be no problem, if the task were to create a gold-based currency or if there had been a sufficiently strong central political power to impose a single currency. However, given the situation as it stood, a fiduciary currency necessarily based on national foundations raised many sensitive issues, i.e. the purchasing power of the individual currencies or, in other words, the reliability of individual countries or their central banks. Binding the different currencies together through fixed exchange rates would have been the ideal solution, but fixed rates required that conditions in the participating countries converge sufficiently in order to maintain such a system.

[7] *Ibid.*, p. 140

[8] *Ibid.*, pp. 141 *et seq.*

Fazio gave the example of the Bretton Woods system and the EMS as two situations where conditions allowed fixed exchange rates to survive, albeit in different time periods and geographic areas. In the former, the experiment succeeded because it was based on a currency that could be converted into gold at a fixed rate ($35 per ounce). The second worked because it was based on the currency of a low-inflation region.[9] Moreover, both experiments also succeeded because the monetary and fiscal policies of the individual countries involved were coordinated effectively. Thus, the key condition was effective coordination of monetary policies aimed at economic stability. If these conditions did not exist, or rather if they did not prevail simultaneously in all economies, any restrictive policy imposed by one country could be avoided by obtaining credit in another country.[10] Obviously, in a monetary union exchange-rate adjustments would not be possible. One of the most sensitive aspects of the problem, was, therefore, the divergence in conditions in different economies, as a single monetary policy would not be effective or optimal in a monetary union imposed on systems with differing economic structures and different cyclical and inflation patterns.[11]

In addition to the close coordination of Community policies, another requirement was a "rigid general agreement on the total volume of the monetary base in the system, and hence, *de facto*, on its distribution among the participant countries".[12] As regards Italy, Fazio did not hesitate to make "exigencies of international openness and coordination, first of all with the other European countries" dependent on the "restoration of fiscal policy flexibility for potential countercyclical action". It was therefore crucial to readjust the public finances, i.e. to contain the growth of expenditure and rationalize revenues so as to achieve greater equity and efficiency. Nevertheless, integrating Italy's real economy and the financial system was a gradual process and it was necessary that Italy's economic fundamentals and performance converge with those in the other countries. Good economic performance, i.e. growth in output and employment, depended on domestic economic policies. It would not "simply follow automatically from greater international openness of the financial and credit sector".[13]

4 Transition towards Europe and fiscal policy

Fazio sought to warn that Italy could not integrate with the rest of Europe without clear objectives, a precise timetable and, above all, an awareness of the changes that needed to be made in the economy. In this light, it was argued that fiscal policy should be used to manage demand in the short term and bring about

[9] Antonio Fazio, "Problems of European monetary and financial integration", *Review*, XLIII, 2 (May-August 1989), pp. 195 *et seq.*

[10] *Ibid.*, pp. 198 *et seq.*

[11] *Ibid.*, pp.98-199.

[12] *Ibid.*, p. 199.

[13] *Ibid.*, p. 200.

the medium-term economic changes required. For fiscal policy to be effective, it would have to be supported by a restrained incomes policy in order to counter the risks of inflation and declining competitiveness.[14]

Inflation was, in fact, rising in the spring and summer of 1988, despite the dampening effects of the exchange rate. The treasury borrowing requirement overshot targets once again and helped to keep consumption high, making some degree of control over aggregate demand necessary. The monetary authorities had progressively less room for manoeuvre and the situation threatened to become rapidly ungovernable. Since neither interest rates nor the monetary base could be adjusted, the only option was to exercise tight control over the borrowing requirement. It was suggested that, not only should the tax base be widened in order to increase revenues, but also that expenditure be contained, first and foremost by removing the indexation mechanisms that generated automatic increases in real spending.[15]

5. Banks and the financial market

Throughout the 1960s and the early 1970s, the Italian financial markets had been extremely stable, creating no special difficulties for the banks. There had therefore been no stimulus for innovation. For example, in the early 1960s medium and long-term fixed-income securities absorbed 20 per cent of annual flows of financial wealth, while bank deposits, the only short-term financial asset available, accounted for between 33 and 40 per cent. To encourage the sale of government securities to small investors, beginning in 1966, the Bank of Italy therefore pursued a policy aimed at stabilizing securities' prices, ensuring a positive long-term real interest rate that, although low, was still higher than that on short-term assets, such as deposits.[16]

Nevertheless, at least one disturbance affected the financial market in the early 1960s, the source of which was the government. As the budget deficit increased, the government began to borrow money from the Credit Consortium for Public Works (Crediop), which in turn transferred the bonds it had issued to the banks in exchange for loans to the government.[17] The entry of the government into the bond market removed financial institutions such as Crediop from their institutional roles and weakened the stock market.[18] Above all, however, it gradually absorbed increasing quantities of capital. For example, at the end of

[14] Mario Arcelli, "Monetary and fiscal policies in Italy in the present phase of transition toward Europe", *Review*, XLIII, 2 (May-August 1989), p. 201.

[15] *Ibid.*, p. 207.

[16] Michele Barbato, "The evolution of monetary policy and its impact on banks", in *Review*, XLI, 2 (May-August 1987), p. 172.

[17] P.F. Asso and Marcello De Cecco, *Storia del credito. Tra credito speciale e finanza pubblica*, (La Terza, Rome-Bari, 1994).

[18] Luigi De Rosa, *Banche e lavori pubblici tra le due guerre (1919-1939). Il Consorzio di credito per le opere pubbliche*, (Giuffre, Milan, 1979).

the 1970s, the share of total domestic credit absorbed each year by the enlarged public sector was around 70 per cent.[19]

6. Subsidized credit

Another source of distortion in the financial market was the enormous growth in subsidized credit. Credit on concessionary terms had also been used before the war but it began to grow significantly in the 1950s. Used to promote the industrialization of the South and the development of depressed areas in the Centre and North,[20] subsidized financing expanded considerably after 1965, when the "planned contracting" system led to the establishment of large-scale industrial plants in the South. Additional incentives were added in 1968. According to Antonio Marzano, between the first half of the 1960s and the first half of the 1970s, some three fifths of new loans at medium and long term were granted at concessionary rates. Once subsidies had been taken into account, investors in the South faced nominal interest rates of only 1.82 per cent. The legislative framework governing the sector was reorganized in 1976-1977 with the establishment of the National Subsidy Fund, the Industrial Reconstruction Fund and the Export Credit Insurance Agency. Between 1973 and 1978 subsidized credit more than doubled, increasing by about the same proportion as unsubsidized credit granted by the special credit institutions, bank lending and fixed investment.[21]

As subsidized credit increased, the problem of finding funds for such lending arose. One step taken in this direction was to allow the banks to include

[19] Paolo Savona, "Real and financial capital in Italian economic development: Some remarks", *Review,* XXXIV, 2 (June 1980), p. 301.

[20] The government did not provide development aid to the South alone, however. Law 647 of 10 August 1950, the same law that launched the programme of measures in favour of the depressed areas of the South, also included the Maremma zone of Tuscany and Latium, the Po delta and lower Friuli, owing to the difficulty of defining "depressed area" (see V. Giovannelli and E. Scott, "New policy for the depressed areas of central and northern Italy", *Review,* XXI, 4 (July 1967), pp. 270-271). Some 200 billion lire had gone to these areas by 1960. Financing totalling 50 billion lire was granted to the depressed areas of the Centre and North under Law 547 of 15 July 1954, while public works in the area received 158 billion lire under Law 635 of 29 July 1957 and subsequent amendments between 1958-59 and 1964-65. A further 12 billion were allocated under Article 24 of Law 622 of 24 July 1959. Finally, Law 17 of 19 January 1963 authorized another 5 billion lire for the depressed areas of the Centre and North. Overall, between 1950 and 1965 the depressed areas of the Centre and North received 425 billion lire in financing (*Ibid.*, p. 276). All the regions in the area received funds but the largest amount went to Friuli-Venezia Giulia, with about 67 billion lire, followed by Tuscany (about 57 billion), Emilia-Romagna (about 53 billion) and the Marches (more than 29 billion). The funds were used for the construction or upgrading of water supply, roads, land reclamation and irrigation. In 1966 yet another law (Law 614 of 22 July 1966) was enacted in favour of depressed areas, providing subsidies for public works and incentives for the development of productive activities, especially in mountain areas (*Ibid.*, pp. 277-280, 281, 289 *et seq.*). In subsequent years, the industrial crisis increased the number and size of depressed areas in the North and Centre.

[21] Antonio Marzano, "Credit subsidies and efficiency", in *Review,* XXXIV, 2 (June 1980), p. 307.

government-guaranteed securities issued by institutions authorized to grant subsidized credit in their compulsory reserves. Only after the chemical industry crisis in 1977 did subsidized credit show signs of slowing. In 1978 the securities investment requirement for banks was eased, which enabled them to reduce their purchases of securities issued by the special credit institutes in the second half of the year. According to Marzano, the amount of subsidized credit granted until then had been excessive, an excess that had caused a significant weakening of a number of industrial sectors while creating an artificial abundance of capital in certain areas of the country. These circumstances artificially stimulated capital-intensive investment that was ill-suited to solving the unemployment problems in these areas.[22]

The 1980s saw the emergence of a debate about the benefits of subsidized credit, and both sides could boast distinguished supporters. Critics underscored the difficulties that subsidized credit created for selecting projects on the basis of their productivity and pointed out the corrupting effect it had, in the sense that granting such loans helped to obtain the agreement or meet the demands of the groups that benefited most from individual rescue or restructuring assistance. The system created inflationary pressures and led to the crowding out of more productive investments. Nevertheless, the critics did not deny that subsidized credit could be used profitably to help firms to adjust to changing market conditions and technological developments, and remove geographic and sectorial imbalances.[23]

The defenders of the system first noted that such lending was widely practised in all industrial countries. Some also distinguished between subsidized credit to large companies and that to small and medium-sized firms, arguing that, in 25 years of such lending, the latter had shown no signs of anomalous development. They did admit that the situation with large companies was different, arguing that the problems were a consequence of the fact that Italy had few large firms and few large medium and long-term credit institutions, which led to an excessive concentration of risk with a small number of credit institutions. The danger could have been avoided by creating financing consortia in which most banks and other credit intermediaries of any size could participate. The special credit institutions would play a coordinating role in these consortia and would provide participating lenders with a detailed assessment of the technical, economic and financial situation of the recipient firm and the proposed investment.[24]

7. The transformation of the banking system

The debate on subsidized credit was, in fact, the offspring of the extraordinary changes that had taken place in the economy. By now, saving and investment

[22] *Ibid.*, pp. 321 *et seq.*
[23] *Ibid.*, p. 323.
[24] Like the director of Mediocredito Centrale, Figliola-Baldieri.

were widely separated. The changes had first affected lending and had been accelerated by the need to finance the budget deficit. Especially after the crisis of 1973, the budget deficit was financed by the creation of money, which worsened inflation and increased the funding needs of firms, which, owing to restrictions imposed by the Bank of Italy, could not easily issue bonds in the financial market or turn to the stock market. They were therefore forced to borrow heavily from the banks. The special credit institutions also had to take a similar road. As recalled by Michele Barbato, between 1970 and 1972, against a background of rising inflation, the banks became the increasingly dominant centre of the national financial intermediation system. In order to prevent this from imparting a further boost to inflation, the Bank of Italy took action, using administrative instruments rather than interest rate adjustments. In March 1973, even before the economic situation deteriorated in the wake of the oil crisis, it imposed both a securities investment requirement and a lending ceiling.

The appendix to Barbato's article provides the details of the structure of both measures as well as data showing the extent of their impact on bank fund-raising and lending.[25] The more striking aspect of the situation was that what were intended to be temporary measures actually remained in place for years, being regularly renewed, except for a few amendments, and with only a short interruption for the lending ceiling. At the end of 1982, the restrictions were still in force and were even more onerous than they had been when first imposed. Moreover, in the intervening years changes had been made to the mandatory reserves and, in some years, limits were imposed on foreign-currency financing for imports and on bankers' acceptances.[26]

Barbato's reconstruction shows that the 1970s had been just as arduous for the financial system as had been the case for the monetary system. The oil crisis in 1973 had created severe balance-of-payments difficulties for the Bank of Italy, which sought a response that would reconcile the external balance and a tolerable rate of inflation with the need to maintain a sufficient level of domestic economic activity. The strategy adopted was to control the volume of credit flowing to the final users (the government and firms), using total domestic credit as a target aggregate and establishing how much of the overall volume was intended to flow to the public sector and how much to the private sector.

As ingenious as the scheme was, it was not a very practicable approach, since the amount allocated to the Treasury was not, and has never been, the amount shown in the budget. The figure would increase steadily during the year, eliminating any possibility of placing government securities with households, which, given their fears that inflation would worsen, sought to remain liquid, preferring to hold bank deposits instead. These deposits then funded the purchase of government securities by the banks rather than depositors, as the

[25] Barbato, "The evolution of monetary policy", pp. 171, 202 *et seq.*

former were forced by the securities investment requirement to transform a large proportion of deposits into government securities, a constraint that was reinforced by the ceiling on lending to the private sector.

The need to reduce the balance of payments deficit prompted the authorities to place restrictions on capital movements abroad. Foreign investment, which flowed through the banks, had reached 26 per cent of annual flows of household financial assets in 1969,[27] but fell to 7.9 per cent in 1971, 3.7 per cent in 1973, 1.2 per cent in 1975 and recorded net disinvestment of 0.3 per cent in 1977. Investment subsequently recovered slightly to 0.1 per cent in 1979, 0.6 per cent in 1981, 0.1 per cent in 1982 and 1983 and 0.5 per cent in 1984 before turning negative in 1985 with disinvestment of 0.2 per cent.[28]

Forced to operate under these constraints, banking was essentially transformed into passive asset management on behalf of third parties, with households' decisions and monetary policy determining investment decisions. The banks' main function was essentially treasury management, with no strategic decision-making involved in raising and using funds. Management skills therefore deteriorated, with serious consequences.

The years following 1979-81 have a key place in Barbato's chronological breakdown of the period. With the decline in inflation and the balance of payments deficit, Italy showed that it had absorbed the impact of the oil shock. It was this success, together with the need to improve the operation of the government securities market, that prompted the Bank of Italy to consider revising market regulations and reverse the trend away from intermediation that had affected the banking sector in those years. As we saw, despite high inflation in Italy between 1972 and 1981 that eroded household savings, households were attracted by the higher yields offered by Treasury bills and their short maturities and had largely abandoned bank deposits.[29]

8. Innovation and new banking strategies

The banks reacted to the contraction in traditional fundraising by expanding banking-related activities and introducing innovations such as acceptances and expanding their guarantee commitments. Banks and special credit institutions also acquired a major presence in leasing and factoring. According to Vincenzo Pontolillo, between 1979 and 1981 the number of leasing companies in which ordinary banks had an interest nearly doubled from 26 to 44, while those in which special credit institutions had holdings rose from 0 to 12.[30] At 31 December 1981, the banks' interest in leasing companies had risen to 215 billion lire and

[27] *Ibid.*, p. 175.
[28] *Ibid.*, p. 176.
[29] See Chapter 16, Section 4.
[30] Vincenzo Pontolillo, "Analisi dei mercati e degli intermediari e dei prodotti", *Economia italiana*, 3, 1982, supplement, p. 53.

bank lending to leasing companies had increased to 560 billion lire,[31] while the value of leasing contracts were forecast to reach 1-1.5 trillion lire.[32] According to Databank, the value of leased goods alone was more than 1,910 billion lire in 1980.[33] The involvement of banks in factoring was equally extensive, although according to Arcelli, "as in leasing, the resumption of output growth prompted the leading industrial groups to enter the factoring sector as well, seeing an opportunity to capture more of the derived demand by offering factoring services to their own suppliers". According to Databank, turnover in factoring was an estimated 2,250 billion lire in 1981.[34]

The stock of outstanding banker's acceptances, which had also undergone innovation, reached 3,663 billion lire at the end of 1981 but the trend was downwards owing to the strict rules governing their issue and the tax treatment imposed that year.[35] Other activities were emerging alongside these lines of business in banking-related areas such as share and bond issues and the direct placement of atypical securities like real-estate investment certificates, equity notes and financial certificates, which directed household savings towards financial "hedge goods" such as buildings and land. While atypical securities were a relatively new phenomenon, especially as regards the volume now being recorded in this business, an older area of bank-related activity was fundraising by securities investment trusts.[36]

Not all of the new financial products were being offered by well-established institutions. New and sometimes less-than-sound operators also emerged in the sector, hence the lack of enthusiasm for atypical securities. There were doubts about whether the securities should be admitted for trading precisely because many of the issuers had such fragile asset-structures and weak capital bases (one case cited as an example involved an issue valued at 20 billion lire by a company with only 200 million lire in capital). Moreover, many had no procedures for diversifying risk and were not subject to supervision.[37] In other words, these firms were a potential source of instability that could have had disastrous consequences for the entire financial system.

The main reason middle-class investors diverted their savings away from the stock market and real estate towards new types of investment after 1960-65 was to avoid heavy taxation. In addition to the small size of dividends, investment in the stock market was discouraged by the registration requirement for shares, the progressive taxation of individuals' incomes and, until it was eliminated, double taxation. As for real estate, investors were put off by rent controls, which

[31] Mario Arcelli, "Caratteristiche evolutive dei mercati monetari e finanziari", *ibid.*, p. 28.
[32] Pontolillo, "Analisi dei mercati", p. 53.
[33] Arcelli, "Caratteristiche evolutive", p. 28.
[34] *Ibid.*
[35] *Ibid.*
[36] *Ibid.*, p. 29.
[37] Luigi De Rosa, *Dieci anni di economia italiana 1979-1989*, Banco di Roma, Rome, 1990, pp. 153-154.

in practice were "a form of discriminatory taxation, often imposed in inverse relationship to ability to pay", as well as by a variety of taxes, ranging from capital-gains tax on nominal rather than real values (i.e. the tax on building areas) to the imputed capital-gains tax on property, not to mention the ever-present threat of a highly distorting wealth tax.[38]

Whatever the reasons for their emergence, the new intermediaries and their products were by now a reality and could not easily be dislodged, although since they were raising funds "with the public", the authorities could not delay action to bring them under their control any longer. In fact, it was now more necessary than ever. Many hoped that authorization would be granted on a case-by-case basis, establishing which operations the intermediaries could engage in.[39]

9. The special credit institutions

Another change emerging from the legislative reforms of 1981 involved the special medium and long-term credit institutions. They had developed a much more extensive geographical reach, with much greater scope for fund-raising and lending than before. They had also increased their short and medium-term lending, the traditional preserve of the ordinary banks, which were forced to surrender an ever-larger portion of their market to their new competitors.[40]

Between 1979 and 1984 these institutions found themselves facing a fall in credit demand from large companies and in the search for new opportunities they broadened their lending to small and medium-sized firms. As a result, the average size of loans declined and operating costs rose. inflationary pressures forced them to take on the banks in both fund-raising and lending. While lending rates had to face competition from corresponding bank rates, those on bond issues and certificates of deposit were still subject to authorization. As a result, despite having introduced variable rates and options on the duration of loans, the industrial credit institutions were still forced to manage exchange-rate risk actively. Hence their interest in foreign-currency loans, which enabled them to shift the cost to the financed firms.[41] They also ventured into government securities in the search for higher profits, at least beginning in 1982, and their investments in such securities quickly mounted as earnings rose, so much so that there was a danger that the special credit institutions were gradually losing the characteristics that defined their institutional role. In fact, Crediop, IMI, Mediobanca, Efibanca, Interbanca, Centroban. Isveimer, Irfis and Cis all became less liquid to varying degrees between 1979 and 1983.

[38] *Ibid.*, pp. 154-155.
[39] G. Guarino, "Conclusion", *ibid.*, pp. 156-157.
[40] Arcelli, Caratteristiche evolutive", pp. 30 31; Sabino Cassese, "The division of labour in banking. The functional and geographical distribution of credit from 1936 to today", *Review*, XXXVII, 3 (October 1983), pp 401 *et seq.*
[41] Alberto Beoni, "The trend of banking profitability in Italy: Determinants and prospects for 1984", *Review*, XXXVIII, 2 (June 1984), pp. 169 *et seq.*

Liquidity in the form of deposits declined sharply, falling from 93 per cent of total liquidity in 1974 to 24 per cent in 1984. Government securities were considered to be even more liquid than deposits, with the result that money holdings fell to very low levels. The outcome was a highly atypical situation in which liquid funds were invested in government securities, which earned more than loans, had relatively low costs compared with lending and were less risky.[42]

Securities intermediation was another feature of the transformation of medium-term credit institutions. Through subsidiaries or affiliates they entered new sectors, such as portfolio management, investment and merchant banking, industrial monitoring and so on, a change that effectively moved them from the "public" to the "private" area, where they were concerned, not with implementing the decisions of policymakers and administrative authorities but rather with earning a profit in a market-based framework of independent decision-making.[43]

10. The banks and the difficult years of 1981-83

The system began to change in 1981, and until 1983 the banks went through a difficult period, even more so than in the years between 1974 and 1979. In 1982-83 the Bank of Italy amended the compulsory reserve regime, including funds raised with securities re-purchase agreements among those subject to the reserve requirement and raising the reserve ratio. The measures were intended to reduce bank liquidity even further and, in fact, it did subsequently contract significantly. The banks responded by increasing their lending rates to more than 26 per cent in 1982, while deposit rates averaged about 13.2 per cent. The spread between the two rose from 8.9 percentage points in 1979 to 11.95 points in 1983.[44]

The increase in lending and deposit rates and the rate differential was not the banks' only reaction. They also sought to reduce costs by reorganizing their operating structures to increase efficiency and expanding their use of new technology. They also broadened the range of services offered and introduced innovative products, while adding new internal functions such as marketing and planning. Law 77 of 23 March 1983 authorized the establishment of investment funds, with the form of control over such funds being clarified by Law 281 of 4 June 1985.[45] Investment funds received a warm welcome and, as early as 1986, they absorbed about 26 per cent of new household financial assets.[46]

[42] Maria Teresa Salvemini, "Medium-term credit institutions' liquidity management: Trends and problems", *Review*, XL, 1 (January 1986), pp. 20-23.
[43] *Ibid.*, p. 21.
[44] Barbato, "The evolution of monetary policy", p. 185.
[45] G. Cammarano, "Contribution of investment funds to the development of the financial market in Italy", *Review*, XL, 1 (January-April 1986), p. 46-58
[46] Barbato, "The evolution of monetary policy", p. 176.

11. Changes in the 1936 Banking Law

The Italian banking system was now crowded with new institutions and instruments for both fund-raising and lending, leaving it radically changed from the system envisaged by the 1936 Banking Law. The Banking Law had organized the banking system along functional lines, and according to scale, establishing that banking functions proper were to be carried out by national-level public-law institutions (Banco di Napoli, Banco di Sicilia, Banca Nazionale del Lavoro, Istituto San Paolo di Torino and Monte dei Paschi di Siena) and by the banks of national interest (Banca Commerciale Italiana, Credito Italiano and Banco di Roma), with which local and regional banks were to cooperate in their respective areas. Incorporating the substance of agreements between each of the three national-interest banks and IRI in 1933, the law also provided for the separation of the Italian credit system into industrial credit and ordinary credit, adopting the principle of bank specialization.

The geographical structure and the functions of the banking system laid down by the Banking Law gradually underwent far-reaching modification. The changes began after the war, especially from 1948 onwards. Bank branches were opened in towns that had previously been without banking services, with preference being given to small and medium-sized banks. At the same time, foreign activity was restricted to the public-law credit institutions and the banks of national interest. Thus, between 1948 and 1984, the public-law banks saw their share of total branches decline from 17.41 per cent to 15.08 per cent, while the banks of national interest saw their share drop from 9.76 to 7.84 per cent. The share of the ordinary credit banks, which included banks of varying dimensions, fell from 27.22 to 25.32 per cent. By contrast, increases were recorded by cooperative banks (from 15.95 to 20.64 per cent) and, to a lesser degree, savings banks (from 29.66 to 31.2 per cent).[47] The number of agency banks also rose from 12 in 1962 to 256 in 1984. In July 1984, the number of banks authorized to operate on a national scale had risen from 20 to 109, while those authorized to operate in more than one region increased from 29 to 191.[48]

Beginning in 1969, authorization to engage in foreign operations, which the 1936 Banking Law had restricted to large banks only, was extended to other credit institutions as long as they had a sufficiently strong capital base. In the ten years between 1973 and 1982, the major banks' share of the lending market fell by more than 7 percentage points, while their share of deposits fell by about 5 points.[49] Nevertheless, at 30 June 1985, the 30 largest banks managed 560 billion lire, equal to 78 per cent of the total. Of these, 10 managed 70 per cent of the

[47] Ercole Ceccatelli, "The role of the major banks in Italy: Problems and prospects", *Review*, XXXIX, 3 (September-December 1985), p. 368.
[48] *Ibid.*, p. 368-369.
[49] Antonio Marzano, "Conditions in the Italian economy and banking margins", *Review*, XXXVIII, 2 (June 1984), p. 158.

group's total resources, 60 per cent of liabilities with customers and 67 per cent of loans. The weight of the 10, which comprised the three banks of national interest, the five public-law banks, one savings bank (Cariplo) and one private bank (Banca Nazionale di Agricoltura), was also considerable in the areas of securities trading, foreign exchange and services, where they held 70 per cent of the market.[50]

This group also had a significant presence in the medium and long-term credit sector, where they held about 46 per cent of the market through institutions in which they held an interest.[51] Their activity in this sector was a reaction to the sharp increase in the number of medium and long-term credit banks, which threatened to separate fund-raising from lending even further, damaging them considerably, much as they were later harmed by the provision on the compulsory reserves and the securities investment requirement. Since most of the special credit institutions made loans on the basis of decisions taken by political and administrative bodies, their operations were essentially reduced to administering funds raised by others and lending on the basis of the decisions of others. As observed by Sabino Cassese, the years following the war saw the progressive erosion of the principle of functional separation and the quiet beginning of "despecialization" in banking.[52]

12. Towards a new banking system

Faced with such sweeping changes, it was felt that the time had come to complete the transformation and "eliminate the remaining obstacles created by the limits imposed in the thirties; make all the various categories of banks completely uniform under the supervision of a central authority; allow everybody to do everything". This would produce "a new specialization, no longer laid down a priori by law but reflecting the talents of the various banks competing between themselves under the new rules".[53] In 1984 the focus had already shifted to deregulation, and competition was being promoted as the basis for the development of the system, a process that might even lead to greater concentration.

With the gradual broadening of markets, concentration had become an operational necessity. However, it was noted that concentration and fragmentation would interact owing to the fact that the competitors of the large banks would be growing more rapidly than they were, inducing them to undertake additional mergers.[54] The world's leading banks would thus become ever more universal,

[50] Lamberto Dini, "The Italian case: Balance sheet trends", *Review*, XXXIX, 3 (September-December 1985), pp. 331-332.
[51] *Ibid.*, p. 331.
[52] Sabino Cassese, "Major banks and new legislative structures", *Review*, XXXIX, 3 (September-December 1985), p. 391.
[53] *Ibid.*, p. 390.
[54] J. Revell, "The structures of the credit systems: Concentration and fragmentation", *Review*, XXXIX, 3 (September-December 1985), pp. 397 *et seq.*

even if their business grew less rapidly than in the past. In other words, despecialization seemed set to continue.

Despide this trend, Paolo Savona argued that the large Italian banks were not yet mature enough to aspire to mega-bank status. For this to happen they would first have to promote a more efficient and less costly domestic and international payment system, free the financial markets of the burden of the public finances, reduce staff costs, persuade legislators to ease the regulation of the credit system, foster greater international openness in the financial markets and, above all, eliminate the dominant public role in the ownership of banks.[55]

Public ownership placed a limit on the bank's ability to raise capital, especially in the case of the public-law banks and the banks of national interest. At the end of March 1956 the banks of national interest had increased their own funds by a factor of 6.34 since 1938, while those of banks entirely or mainly in private hands had expanded by a factor of 25, with a maximum of 44 for the mutual banks.[56] The gap increased with time and it was not until the mid-1980s that the banks of national interest were allowed to raise significant amounts of capital through share issues.

The need to strengthen the capital bases of the large banks was born of changes in the international environment, characterized not only by the extraordinary growth of the financial markets but also by the size and speed of information flows. Institutional changes included the contraction of the bank intermediation sector, the blurring of the distinction between banks and other financial institutions, and the greater competition with new types of intermediary. Associated with structural change came the increased liquidity of financial assets, the narrowing of the difference between money and other financial assets, the uncertainty of exchange rates caused by the rapid shifting of funds from one market to another and a range of other factors.[57]

What was being done in Italy to foster the growth and international expansion of the large Italian banks? We have already examined the gradual erosion of the dominant position of the banks of national interest and the public-law banks in the Italian banking system, but the government had done even more to prevent their growth. As recalled by Ercole Ceccatelli, it had also used the securities investment requirement to force the large credit institutions to act more like savings and loan associations than commercial banks, while it employed the lending ceiling (until its removal in 1983) to enable "the smaller banks to gain new customers and acquire a larger share of the business of the borrowing firms",[58] not to mention other measures that had reduced the presence and

[55] Paolo Savona, "Round table", *ibid.*, pp. 450-451.

[56] Dini, "The Italian case", pp. 336-337.

[57] Guido Carli, "The internationalization of the financial and credit system", *Review*, XXXIX, 3 (September-December 1985), p. 342 *et seq.*

[58] Ceccatelli, "The role of major banks", p. 369.

operations of the major banks throughout Italy and fostered the expansion of non-bank and ancillary financial services into the credit intermediation sector.

Turning back the clock was impossible. What needed to be done was to learn whatever lessons could be gained from the experience and attempt to direct the Italian banking system towards a model that was more appropriate to the needs of a growing and changing economy and the innovations that had taken place in domestic and international markets. The most widely recommended course of action, advocated by bankers and academic experts alike, was to "de-specialize" the major banks and allow the formation of universal banks able to lend at both short and medium term, as well as engaging in merchant banking.

After the lending ceiling was abolished in 1983, banking went through a period of relative calm for a couple of years. However, at the end of 1985 a new currency crisis exploded and foreign-currency lending expanded rapidly on expectations of a devaluation of the lira. At least at the outset, the Bank of Italy was unable to keep the situation under control. Only at the end of December was it able to engineer an increase in market interest rates, which then rose rapidly from 16.85 per cent to 17.82 per cent in January 1986 and to 18.71 per cent in February.[59] Uncertain about the effectiveness of raising interest rates alone, especially as it had to consider the level of rates on government securities, on 16 January 1986 the Bank of Italy reinstated the credit ceiling. It was nevertheless a temporary measure, as at the end of June that year the limit was removed once again. The securities investment requirement, which had been renewed at the end of 1985, remained in force, however, and the rate of interest paid on the compulsory reserves was lowered in November 1986.[60]

[59] Michele Barbato, "Evoluzione della politica monetaria e impatto sulle aziende di credito", *Economia italiana*, 1987, 2, pp. 208 *et seq.*

[60] Barbato, "The evolution of monetary policy", p. 208.