

## *Industry and Finance in Italy, 1918-1940*

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The aim of the present paper is to show how the developments of the early Twenties affected subsequent events by determining new financial patterns and new relations between Finance and Industry as well as a more straightforward policy of state intervention; how, in turn, economic policies influenced industrial financing as well as the behaviour of the banking system and of the public in the various phases of the cycle; how a new organization of the financial system was created and consolidated to the point of lasting, with minor adjustments, to the present day.

Contrary to the prevailing opinion, the twenties rather than the first decade of the century seem to be the moment when the so-called "mixed banks" came to control a substantial portion of Italy's large industrial firms. The process had two phases. The first one (1922-25) was characterized by conditions particularly favourable to the "mixed banks" both in the real and in the financial markets.

In the second phase (1926-29) the increase in the portfolio of industrial equities and in long-term lending was determined by the need both to avoid too rapid a fall in the market price of equities and to support industry at a time of weaker demand.

The watershed between the two phases can be identified in the deflationary demand and income policies followed to restore the gold standard at a parity of 90 lire to the pound (the so called *quota 90*).

During the Great Depression of the thirties, the objective of keeping the lira on the gold standard maintained priority. Nonetheless, increasing recourse was made to exchange control, and, on the all, monetary and fiscal variables moved in an anticyclical way. The banking system underwent significant structural changes, but succeeded in escaping a generalized liquidity and solvency crisis. This was limited to the big "mixed banks" albeit involving the central bank itself. The State had to step in on a large scale, through interventions — the creation of I.R.I. in 1933 and the new banking law in 1936 — which reshaped the relationship between Industry and Finance.

### 1. *The Main Trends of the Period*

The rate of growth of Italy's real GNP between 1921 and 1938 averaged 2.2 per cent a year. This figure is in line with the secular trend (1861-1967) but below the records of the periods of "catching-up" of this latecomer to European industrialization in the twenty odd years preceding the first World War and in those following 1945.<sup>1</sup> The overall performance of the Italian economy in the inter-war years was, needless to say, the result of pronounced cyclical movements; at the same time, it resulted in important changes in the composition of the real economic aggregates.

Italy's business cycles in the period 1919-1940 can be roughly described in the following way.<sup>2</sup> After the end of the conflict there was, as in most other European countries, a boom followed by a severe slump. Recovery began in the first months of 1922. For the following four years, to the spring of 1926, the rate of growth of Italian manufacturing production was probably the second highest in Europe; agriculture too developed quite rapidly. This short-lived but hectic boom in the first part of the twenties was followed by a slump — the severity rather than the timing of which seems to be connected with the policies pursued in order to return to the gold standard — and a slow recovery beginning early in 1928. The onset of the great depression can be dated at the end of the Summer of 1929, as in most other European countries. The slump was very serious for the industrial sector and lasted longer than elsewhere. Real recovery only began early in 1935 with rearmament for the war in Abyssinia, which produced three years of rapid growth concentrated in the heavy and import-substituting industries. A rapid sequence of slump and recovery preceded the fatal August of 1940.

Trends in production can be summarized by pointing to two phases of rapid growth (1922-26 and 1935-37) framing a decade of stagnation. The latter was, however, characterized by substantial structural changes — with increasing shares of the industrial and services sectors in GNP and of the engineering and chemical industries in manufacturing production — that were partly induced by huge movements in relative prices.

<sup>1</sup> The national accounts and production statistics referred to in the present paper are those produced by Giorgio Fuà's team and presented in P. ERCOLANI, "Documentazione statistica di base", in G. FUÀ (ed.), *Lo sviluppo economico italiano*, Angeli, Milano, 1969, pp. 380-460.

<sup>2</sup> For a description of the methods employed in assessing the turning points and for a detailed analysis of the characteristics of the individual cycles from the point of view of both "real" and financial variables, see G. TONIOLO, *L'economia dell'Italia fascista*, Laterza, Roma-Bari, 1980.

Table 1. % SHARES OF THE TOTAL BALANCE SHEET ASSETS OF THE SYSTEM OF FINANCIAL INTERMEDIARIES OF EACH CATEGORY OF INTERMEDIARY, IN ITALY (I) AND IN THE DEVELOPED COUNTRIES (DCs)

	1 Central banks		2 Commercial banks		3 Thrift institutions		4 Insurance institutions		5 Other intermediaries	
	I	DCs	I	DCs	I	DCs	I	DCs	I	DCs
1913	18	7	19	43	52	19	4	14	6	18
1929	15	9	36	40	36	20	7	16	6	16
1938	12	11	28	30	37	20	11	22	12	17
1957	16	13	36	32	30	19	5	24	13	13

% SHARES OF THE BANKING SYSTEM'S TOTAL BALANCE SHEET ASSETS OF EACH CATEGORY OF BANK

Year	Bank of issue	Ordinary credit banks	Banking houses	Public law banks	Banks of national interest	Savings banks	Post office savings banks	Pledge banks	Cooperative banks	Rural and artisans' banks
1910	22.2	18.3	..	—	—	20.9	24.6	1.8	11.5	0.7
1920	33.4	31.3	..	—	—	11.3	15.1	0.9	7.6	0.4
1930	16.6	34.4	1.5	4.5	—	17.3	16.6	1.2	6.8	1.1
1938	16.1	8.3	0.8	11.2	15.6	15.2	27.5	..	4.5	0.8
1960	16.9	14.5	..	16.5	14.9	14.6	14.8	..	7.2	0.6

Source: A.M. BISCAINI COTULA - P. CROCCA, "Le strutture finanziarie: aspetti quantitativi di lungo periodo (1870-1970)", in F. VICARELLI (ed.), *Capitale industriale e capitale finanziario: il caso italiano*, Il Mulino, Bologna, 1979, tables 7 and 8, pp. 112-113.

In a secular perspective, the financial side of the Italian economy between the wars was characterized by the following main features; a) financial deepening; b) a smaller weight of intermediation, c) an important reorganization of the banking sector and of the entire system of financial intermediation. Let us briefly examine each of these points.<sup>3</sup>

The ratio of the stock of financial instruments to national wealth — Goldsmith's FIR — shows, as in other countries, a rising long-term trend from 0.4 in 1881 to 1 in 1971. Between 1914 and 1938 the ratio rose extremely fast (at nearly 2 per cent per year on average) even though the rate of increase in total and per capita real income in the same years was rather low. Between 1881 and 1914 and between 1938 and 1971 the average annual increase in Italy's FIR was smaller (respectively 0.7 and 1.1 per cent). Between 1914 and 1938 it was greater than the average of the major industrial countries, despite the widening of the gap between Italy's per capita income and that of the other countries.

The ratio of the intermediaries' assets to total financial assets (FIN), which also shows an upward long-term trend, rose particularly slowly in the period 1914-1938. International comparisons of flow data show, analogously, that the ratio of the intermediaries' issues to total issues was lower in Italy than in the other major countries, contrary to previous and subsequent periods.

Within the total activity of the financial intermediaries, there was a marked decline in the share of the banks of issue; a very large increase, partly offset by a sharp fall after 1928, in that of the commercial banks; a decline, during the twenties, in the weight of the thrift institutions; and an increase in the shares of the insurance institution and other non-bank intermediaries. Table 1 shows, furthermore, that the changes were more pronounced in Italy than in the other developed countries.

The aggregate changes just outlined took place mostly in the thirties as an adjustment to changes induced by the depression. However, it should be pointed out that the period 1921-25 was one of hectic banking activity (even of "wildcat" banking to some extent) characterized by a) an increasing weight of banking intermediation, b) a rising share of the "mixed banks", c) a very lively stock exchange market for industrial securities (one of the few such moments recorded in Italian economic history to the present day). The deflationary policies implemented to stabilize the currency and the Great Depression put an

<sup>3</sup> For statistics on the development of the Italian credit system in the interwar period set within the framework of longer term trends, see A.M. BISCAINI COTULA and P. CIOCCA, "Le strutture finanziarie: aspetti quantitativi di lungo periodo (1870-1970)", in F. VICARELLI (ed.), *Capitale industriale e capitale finanziario: il caso italiano*, Il Mulino, Bologna, 1979.

abrupt end to the wild activity of banks and, after 1930, resulted in serious liquidity problems for the most prominent of them which required resort on a large scale to central bank lending. This, in turn, opened the way to policies that brought about a major and permanent change in the structure and style both of financial intermediation and of the relations between state, banks and industry.

This change considerably favoured a shift toward non-banking intermediation.

## *2. The Structure of Financial Intermediation around 1920*

The role played by financial intermediaries is one of the main issues in the debate about the pattern of Italy's industrialization in the fifty odd years preceding the first world war. In Gerschenkron's view the "agents" of industrialization in Italy, given the relative backwardness of the country within Europe, can be identified in the "German" or "mixed" banks.<sup>4</sup> He found that it was only after the establishment of Banca Commerciale Italiana (1894) and of Credito Italiano (1895) that Italy experienced its "big spurt" of growth in manufacturing. The role of these "new" financial intermediaries seems to be crucial — according to Gerschenkron — because, following the practice of their forebearers, they were able to concentrate the scarce supply of loanable funds into key industrial sectors and firms. Furthermore, they could make the best use of entrepreneurial talents that were even scarcer than financial capital. To do this, so the story goes, they had to take a permanent stake and interest in manufacturing companies which they provided with a steady flow of funds and of which they held, in various ways, large amounts of shares.

The debate about the patterns of Italy's industrialization from 1860 to 1914 is still open and does not need to concern us here except, perhaps, for a few remarks about the financial side of the question. One could note, for instance, that the practice of "industrial banking" was very well known in Italy before the crisis of the early nineties. Banca Generale and Credito Mobiliare were "mixed banks" of the French blend of the Peréire brothers and probably quite essential in determining both the spurt in railway construction that followed the unification and the industrial "boom" of the eighties that, as Fenoaltea has rightly pointed out,<sup>5</sup> cannot be easily dismissed as an unimportant episode in the industrialization of the country. More relevant to the present paper, however,

<sup>4</sup> A. GERSCHENKRON, *Economic Backwardness in Historical Perspective*, Bknap Harvard, Cambridge Mass., 1962.

<sup>5</sup> S. FENOALTEA, "Riflessioni sull'esperienza industriale italiana dal Risorgimento alla prima guerra mondiale", in G. TONTOLO (ed.), *L'economia italiana 1861-1940*, Laterza, Roma-Bari, 1978.

is the careful research of Confalonieri on the actual behaviour of the "German banks" and, particularly, of the most prominent of them, the Banca Commerciale Italiana (Comit), before world war one.<sup>6</sup> According to this author the role of Comit as an autonomous promoter of new industrial ventures was not a crucial one and only in the case of the electric power industry can we see a clear strategy for a deliberate intervention by the bank in a sector that promised to yield large profits. Otherwise, long-term financing of a given project was seen by the management of the Banca Commerciale as a way of establishing a permanent connection with a group of businessmen and, thus, acquiring a permanent flow of "normal" commercial operations for the bank. The latter usually underwrote new issues of industrial bonds only to sell them, at a profit, to its own clients.

In any event, while the overall importance of financial intermediation in the process of Italian industrialization before the first world war remains an open and difficult question, there seems to be little doubt that the magnitude of the industrial portfolio of the "mixed banks" throughout that period was never particularly large, probably not exceeding 10 per cent of the outstanding industrial shares. Earlier research by Bonelli<sup>7</sup> on the crisis of 1907 confirms this finding. This point raises the question, crucial to the present paper, of the timing of and the reasons for the acquisition of the industrial bonds that we find in such large amounts in the portfolios of the "mixed banks" in the early thirties.

Italian banking history is not well documented over the period 1915-18. It is therefore difficult to see what changes in the structure and behaviour of the banking system were induced by war finance. On purely quantitative grounds one may note that the relative importance of the "mixed banks" in total bank lending to the private sector increased from 42 to 73 per cent over the period 1914-18.<sup>8</sup> From a more qualitative point of view the important novelty of these years is the emergence of Banca Italiana di Sconto, the off-spring of a steelmaking and engineering concern of Genoa (Ansaldo). The novelty of this case lies in the fact that the bank was established and operated as the financial branch of an industrial enterprise.

After the war, the "mixed banks" participated intensively in the lending boom of the inflationary months that followed the armistice and they were

<sup>6</sup> A. CONFALONIERI, *Banca e industria in Italia 1894-1906*, Banca Commerciale Italiana, Milano, 3 Voll., 1974, 1975, 1976.

<sup>7</sup> F. BONELLI, *La crisi del 1907*, Fondazione L. Einaudi, Torino, 1971.

<sup>8</sup> As a proxy for the "mixed banks" we take the statistics for the Società ordinaria di credito collected and reconstructed in R. DE MATTIA (ed.), *I bilanci degli istituti di emissione italiani 1845-1936*, Banca d'Italia, Roma, 1967, Vol. I, Tome II, pp. 917 ff.

subsequently hit by the industrial slump of 1920-21. Again, we have to say that the monetary and financial history of the post-war cycle is not well known despite its interest as probably a typical case of debt deflation *à la* Fisher. Two banks were caught in heavy liquidity problems: the above-mentioned Banca Italiana di Sconto and the Banco di Roma. The lender of last resort had to step in but the solutions for the two cases were rather different. The Banco di Roma was given enough liquid funds to continue its operations as one of the leading "mixed banks" of the country, while the Banca Italiana di Sconto was allowed to fail. In the latter case, however, a state agency took over the parent industrial concern (Ansaldo). We have here, as Saraceno<sup>9</sup> has repeatedly pointed out, the first case of direct management by the state of an important Italian manufacturing firm. This development was not so important in overall quantitative terms (even if Ansaldo emerged from the war as one of the giants of Italian industry) as it was for the creation of a new institutional arrangement that was to be highly developed in the early thirties.

As a result of the crisis of 1920-21, the position of the Banca Commerciale and Credito Italiano (needles to say entirely in Italian hands by then) was strengthened by the disappearance of their most dangerous competitor. The other important "mixed banks" around 1922 were the Banco di Roma and the Banca Nazionale di Credito.

On the whole, the structure of the Italian banking system after the adjustments that took place in the postwar boom and slump can be described as follows.

In the early 1920s, compared with an average of now developed countries, the Italian system of financial intermediaries was sufficiently endowed with deposit-taking institutions but was lacking in specialized non-bank institutions (Table 1).

There were about 3,600 banks, mostly unit banks since the ratio of branches to banks was no higher than 1.7 (Table 2). The deposit-taking institutions were divided into: banks of issue, commercial banks (mainly in the form of joint-stock companies) and four categories of thrift institutions (ordinary and postal savings banks, cooperative banks and rural banks). The share of the banking system's assets held by the three banks of issue (Banca d'Italia, Banco di Napoli and Banco di Sicilia), which still carried out operations with private non-bank customers, was about one third, or more than twice that of other countries. The four major "mixed banks" — on whose lending the (long payback and high risk)

<sup>9</sup> P. SARACENO, *L'IRI, origine, ordinamenti e attività*, Studies edited by the Ministry of Industry, Vol. III, UTET, Torino, 1956, and more recently his paper at the Banco di Roma Conference, "Banca e industria fra le due guerre", Il Mulino, Bologna, 1981.

Table 2. STRUCTURAL DATA ON FINANCIAL INTERMEDIARIES IN ITALY

Number of:	1912	1920	1926	1936	1951
1. Banks	3,408	3,601	4,657	2,042	1,230
2. Bank branches	4,227	6,012	11,444	7,656	7,814
3. Localities served	..	..	5,000	3,920	4,083
4. Employees in the financial system	47,095	64,139	92,919	68,418	108,778
5. Branches per bank (2:1)	1.2	1.7	2.5	3.7	6.3

Source: A.M. BISCAINI COTULA - P. CIOCCA, *op. cit.*, Table 11, p. 120.

investment of the leading industrial firms depended — accounted for only a slightly smaller share. The remaining third of bank intermediation was carried out by the thrift institutions — especially the savings banks, which specialized in taking small deposits and lending to central and local governments — and the myriad very small banks.

Non-bank intermediaries accounted for only 4 per cent of total intermediation — a fraction equal to no more than 1/5 of that of the other countries — and consisted almost exclusively of real estate, agrarian and insurance institutions. There was only one industrial credit institution, which had been set up during the war by the government to help firms in difficulty and was strengthened when its services were required in connection with the above mentioned takeover of Ansaldo by the State.

### 3. *The Banking Boom 1922-25*

The general economic conditions of the early twenties — low wages, economic recovery in Europe, the displacement of German exports and the depreciation of the lira — were very favourable to a substantial, albeit short-lived, boom of Italian manufacturing.

The rapid growth of the real sector was permitted by a very high elasticity of supply of financial capital to the private sector deriving from: a) an unusually high savings ratio, b) a very rapid decrease of public spending, c) the behaviour of banks as very active financial intermediaries.

Opportunities for banking activities were very large. Between 1922 and 1925 demand and time deposits grew at an average annual rate of 14.4 per cent (2.5 times the growth of national income at current prices). Total bank lending

to the private sector increased at an average annual rate of 23.7 per cent while bank lending to the public sector grew at the much more modest rate of 9.9 per cent.

The number of banks rose substantially (by some 1,000 units) between 1920 and 1926 and so did the number of their branches and that of the employees in the sector (Table 2), an interesting case of the tendency for the banking sector to speculate and overtrade under conditions allowing easy entry into the sector.<sup>10</sup>

The evidence we have about interest rates shows that lending rates were either stable or slightly increasing between 1921 and 1925 (with a sharp jump in short term rates in the latter year for reasons that will be discussed below); there was an increase in the spread between borrowing and lending rates, which, in the case of the savings banks (for which more detailed figures are available), rose from 3.5 to 4.7 percentage points.<sup>11</sup>

Since labour costs per unit of intermediation do not seem to have increased, profits per unit of intermediation are likely to have shown a rise. The figures available for a large sample of joint-stock banks show that between 1922 and 1925 net profits doubled in absolute terms and rose from around 7 to about 10 per cent of own funds.<sup>12</sup>

The surviving balance sheets of the various types of banks, on the other hand, do not permit an assessment of their involvement in the long-term financing of industrial enterprises or an estimate of the holdings of industrial shares in their portfolios. The events of 1930-34, however, indicate that the weight of such securities was very large indeed. A comparison with the previous industrial banking boom of the early 1900s shows (Bonelli, Confalonieri) that during that period the industrial securities in the portfolio of the major banks amounted to some 10-15 per cent of their total assets, a figure much lower than the one emerging from the study of the balance sheets of the major banks during the 1930-34 crisis.

The problem of industrial management by these banks remains open. This is one of those clear instances where only individual case studies can shed light on the essential question, which can be summarized as follows: did banks generally take a strictly financial approach to their industrial interests or did they mainly (or also) adopt the industrialist's approach, which is more concerned with a) the survival of the firm, b) its size and c) long-term rather than

<sup>10</sup> For a general analysis of this tendency, see C. BARCLAY, "Competition and Financial Crises: Past and Present", in *Competition and Regulation of Banks*, University of Wales Press, Bangor, 1978.

<sup>11</sup> Cfr. A.M. BISCAINI COTULA and P. CIOCCA, *op. cit.*, Table 12, p. 125.

<sup>12</sup> *Ibid.*, Figure 2, p. 133.

short-run profit maximization? What scattered evidence we have does not allow any form of generalization. The Credito Italiano, for instance, was dominated to a certain extent by the interests of the electric power industry and it seems *prima facie* that at least some of the bank's financial operations were subordinated to the strategy of that industrial group. The Banca Commerciale on the contrary was in the hands of men of finance: some of its involvements in industrial ventures were purely financial operations aimed either at reaping huge profits in the stock market or, on the contrary, at saving previous investments endangered by the financial or other difficulties of the industrial firms concerned. We have one instance of long-term management of an industrial manufacturing enterprise by Comit, the steel concern ILVA, which does not seem to have been managed too badly — given the poor standards of the time — if compared, for instance, with the already state owned Ansaldo.<sup>13</sup>

The early Twenties were among the very few years in Italy's economic history characterized by buoyant activity on the stock exchange. In the four-year period 1922-25 the share price index rose by 160 per cent. When deflated by the increase in the cost of living, this is a rise that had no precedent on the Italian stock exchange.<sup>14</sup> At any rate the flow of money into industrial securities and the issue of new industrial shares promoted heavy trading; a sharp rise of their price index took place. The major banks were very active in this market: so much so that it seems very likely that many of the industrial securities found in their portfolio after 1930-31 did not derive from deliberate long-term industrial investment but from short-term ("speculative") investments made before 1925 that could not be liquidated owing to the dramatic fall in prices after the spring of that year. The risky forward trading of commercial banks grew from 1922 to 1924 at an annual average rate of 70 per cent.

To sum up, the early twenties were years of high growth of industrial production, and high rates of investment and saving. On the financial side the supply of funds to the private sector was highly elastic, in part because of decreasing government pressure on the financial market.<sup>15</sup> This situation

<sup>13</sup> Cfr. G. TONIOLO, "Crisi economica e smobilizzo pubblico delle banche miste", in G. TONIOLO (ed.), *Industria e banca nella grande crisi 1929-34*, Etas Libri, Milano, 1978, pp. 286-90.

<sup>14</sup> Cfr. A.M. BISCAINI COTULA and P. CIOCCA, *op. cit.*, Figure 4, p. 135, and the sources cited there.

<sup>15</sup> Total lending of the banking system:

Banks of issue:	⎧	to the public sector	58%	38%
		to the private sector	42%	62%
Other banks:	⎧	to the public sector	27%	3%
		to the private sector	73%	97%

Source: R. DE MATTIA, *op. cit.*

offered tremendous profit opportunities to the banking system as a whole and to the more enterprising "mixed banks" in particular, so that their involvement in industrial lending reached a point never previously attained. It is quite safe to assume that a large proportion of the industrial positions in the banks' portfolios at the time of the great crisis originated from operations undertaken in the years 1922 to 1924.

#### *4. From the Return to the Gold Standard to the Onset of the Great Depression*

Early in 1925 the government was worried both by the excess of money creation through the banking system and by the rapid rise in the values of equities on the Milan stock exchange, which seemed to be almost entirely financed by borrowing. Measures were taken to make forward contracts more expensive. These measures were probably introduced at the wrong moment, when the stock exchange was already slowing down. Whatever the cause — which does not need to concern us here — the general index of the Milan stock exchange began to fall in the spring of 1925.<sup>16</sup>

This reversal of the price trend for industrial equities was the first important factor to affect the behaviour of the "mixed banks". Their intervention in the stock market, previously motivated by the huge profit opportunities for their clients and themselves, was in the following months the result of their willingness to limit the fall in prices of those shares that they held in large quantities and, ultimately, to limit their losses. In this way their holdings of industrial securities were further augmented.

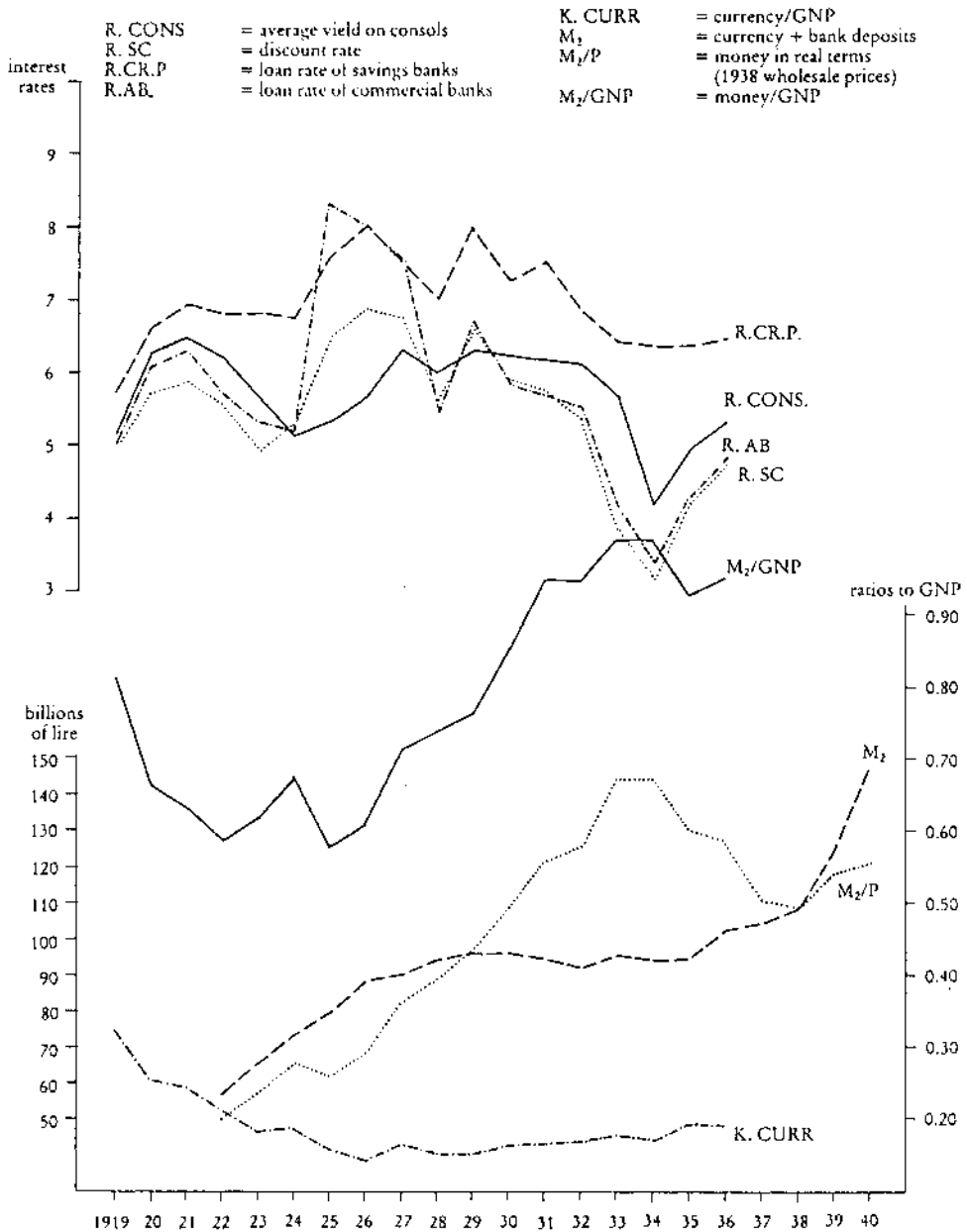
In March 1926 the situation was so gloomy that the four main "mixed banks" formed a "consortium", which received heavy financial support from the Bank of Italy itself, aimed at buying securities in order to support their market price. By the end of the year the Consortium (*Società Italiana Finanziamento Titoli*) had bought and kept in its portfolio industrial securities for 600 million lire without being able to stop the fall of their prices and had to ask the Bank of Italy for a delay in paying back its debt.

What happened in the stock market implied, incidentally, that after 1925 industrial enterprises had to rely more than before on credit from banks to meet their financial needs.

The second crucial element in changing the behaviour of the commercial banks and particularly of the "mixed banks" is to be found in two closely related

<sup>16</sup> Between February and December 1925 the general index of share prices fell by 28 per cent. For more details about these operations see G. TONTOLO, *L'economia dell'Italia fascista*, Laterza, Roma-Bari, 1980, pp. 77-78.

Figure 1. INTEREST RATES, MONEY, AND MONEY-INCOME RATIOS IN ITALY



Source: A.M. BISCAINI COTULA - P. CIOCCA, *op. cit.*; R. DE MATTIA (ed.), *I bilanci degli istituti di emissione italiani 1845-1936*, Banca d'Italia, 1967; ISTAT.

factors: the slowing down of economic growth and the economic policies enacted to bring the lira back to the gold standard and to maintain the new high parity (the so-called *quota 90* or 90 lire to the pound).

The turning point of the cycle (the end of the boom of the early twenties) can be placed in the spring of 1926. At the end of the summer a series of monetary and fiscal measures were taken to implement the so-called stabilization policy that would eventually bring the lira back to the gold standard. As far as we are concerned here, it is worth noting that these policies were of a markedly pro-cyclical nature. They consisted of deflationary measures that relied not only on traditional fiscal and monetary instruments but called upon a political mobilization of the Fascist party to impose generalized wage and price cuts. In this way, much to the astonishment of foreign observers and central bankers,<sup>17</sup> the Italian Government was able to impose a high rate of exchange against the pound and the dollar (30 per cent higher than that chosen by Poincaré in France) and to hold it in the years that followed without much apparent effort. The cost, however, was high unemployment, a slower rate of growth in manufacturing and — as we shall see — a strain on the “industrial banks”.

A restrictive fiscal and monetary stance had already been adopted in 1925 in the face of a 12 per cent increase in wholesale prices, a current account deficit that had risen to 1 per cent of GNP, and capital outflows reflecting the improbability that the gold parity would be re-established at the pre-war level. Public expenditure fell from 35 to 13 per cent of GNP between 1922 and 1926 and in the same years the budget swung from a deficit of 18.9 billion to a surplus of 0.1 billion current lire (Table 3).

Monetary conditions also became more restrictive. In 1925 and in 1926 the whole structure of interest rates rose. Specifically, the average discount rate of the three banks of issue and the lending rates of the commercial and savings banks rose to the highest level of the whole inter-war period in 1926 (Figure 1). In the same two-year period the ratio of both currency in circulation and the money supply ( $M_2$ ) to GNP fell to new lows. In 1925 it was realized that the curb on domestic demand and the depreciation of the exchange rate were not enough to restore domestic equilibrium and, by reducing the current account deficit, external balance.

<sup>17</sup> Cfr. for instance the *memorandum* prepared by R. Warren for Harrison in R.H. MEYER, *Bankers' Diplomacy*, Columbia University Press, New York, 1970, pp. 47-48, but also, more generally, the view expressed by E. MOREAU (*Souvenirs d'un Gouverneur de la Banque de France*, Librairie de Medecis, Paris, 1954) and by Keynes himself (*Tract on Monetary Reform*, McMillan, London, 1923).

<sup>18</sup> Other European countries were similarly affected. Cfr. R. NURKSE, *International Currency Experience*, League of Nations, Geneva, 1944.

Table 3. FISCAL POLICY IN ITALY  
1922-1940

	Public expenditure (in % of GNP)	Deficit of the public sector (in billions of lire)	Deficit of the public sector (in % of GNP)
1922	35	- 18.2	- 18.9
1923	19	- 4.3	- 4.0
1924	17	- 2.0	- 1.8
1925	17	- 1.6	- 1.3
1926	13	+ 0.1	+ 0.1
1927	14	- 2.4	- 1.5
1928	15	- 2.1	- 1.5
1929	16	- 1.5	- 1.1
1930	16	- 1.9	- 1.4
1931	19	- 2.5	- 2.1
1932	23	- 6.0	- 5.4
1933	22	- 5.6	- 5.2
1934	27	- 8.5	- 8.6
1935	25	- 6.0	- 6.1
1936	31	- 15.0	- 13.3
1937	37	- 19.0	- 16.0
1938	29	- 13.0	- 9.2
1939	28	- 14.0	- 9.3
1940	37	- 29.0	- 17.3

Source: G. Fuà (ed.), *Lo sviluppo economico in Italia*, vol. III, Milano, F. Angeli, 1969, Tav. XII.4.8, p. 433.

Hourly wages in industry had already fallen in real terms by 20 per cent between 1921 and 1926, primarily as a result of the increases in the cost of living.<sup>19</sup> To have continued to erode wages by devaluing the external value of the lira would have involved the risk of an accelerating inflation and a consequent undermining of the consensus upon which the fascist regime was based. Thus there gradually emerged the policy of financing the external disequilibria in an initial phase with foreign loans, attracted by the prospect of a revaluation of the lira, and of subsequently defending, if not actually increasing, competitiveness by imposing proportional reductions in nominal wages and prices. The implementation of the first phase was marked by the November 1925 Volpi-Mellon agreement on war debts, the more than 200 million dollars lent by the United States to the Italian government and enterprises during 1926, Mussolini's

<sup>19</sup> Cfr. V. ZAMAGNI, "La dinamica dei salari nel settore industriale", in P. CIOCCA and G. TONIOLO (eds.), *L'economia italiana nel periodo fascista*, Il Mulino, Bologna, 1976.

speech at Pesaro of August 1926 calling on the country "to fight for the lira", the intervention on the foreign exchange market made possible by foreign loans, and the appreciation of the lira from 153 lire to the pound in July 1926 to 110 at the end of October. In 1927 large cuts were made in wages and prices (further wage cuts were to be agreed upon in 1930 and again in 1934). In May 1927 Mussolini indicated *quota 90* as the lira/pound exchange rate corresponding to the new gold parity, which was established at the end of the year.

The curbs imposed on domestic demand in 1926, the fall in foreign demand caused by the loss of competitiveness produced by the delay in cutting nominal wages after the revaluation of the lira to a level at which it was considerably overvalued, and the high and rising *ex post* real interest rates stemming from a largely unexpected deflation all combined to make conditions extremely difficult for enterprises, and especially for those in the industrial sector that were export-oriented and highly indebted. 1927 was a recession year, especially in the industrial sector: GNP fell 2.4 per cent in real terms, while industrial production declined 3.7 per cent. The relaxation of the fiscal and monetary restrictions and, above all, the fact that the cuts in wages in 1927 were larger than those in prices produced a slight recovery in 1928. This was short-lived, however, since it was interrupted by the crisis of 1929. The subsequent cuts in wages up to 1934 were strictly in line with those in prices,<sup>20</sup> so that real wages in industry settled at a sort of rigid floor. The deflationary climate continued to depress entrepreneurial expectations and thus strengthened the tendency for the economy to stagnate. If the decision to stabilize and to go back to gold was perhaps forced by circumstances, the choice of *quota 90* undoubtedly gave the Italian economy, and especially the sectors producing tradable goods, a recessionary bias.<sup>21</sup>

The major "mixed banks" and particularly the Banca Commerciale were in fact strongly opposed to the high value placed upon the lira. Rather they favoured a return to the gold standard at a parity of about 120-110 lire to the pound. This shows their concern for the performance of the industrial sector and of the economy as a whole since in purely financial terms, given the structure of their foreign liabilities they actually stood to gain from an overvaluation of the lira. But, as it turned out, a slower rate of growth meant lower margins on domestic lending to industrial enterprises and a much lower rate of

<sup>20</sup> *Loc. cit.*

<sup>21</sup> Estimates currently being made by P. CIOCCA and A. ULIZZI on the real exchange rate of the lira (*vis-à-vis* its 6 main trading partners) show a loss of price competitiveness of 8 per cent in 1926 and of 11 per cent in 1927. The wage cuts produced a slight recovery of the index in the following two years.

increase of bank deposits (these grew at an average annual rate of 16.6 per cent between 1922 and 1926 and of only 3.7 per cent from 1926 to 1929).

All in all, this situation probably meant a higher demand for credit from industry and the necessity for banks to shift to sources of finance other than deposits. Encouraged by the government, in fact, the main Italian banks borrowed heavily abroad, mostly on a short-term basis, from 1927 to 1929. They also had greater recourse to advances from the central bank.

### 5. *The Great Depression, Monetary Policy and the Banking World*

Between 1930 and 1932 production in the manufacturing sector declined by from 15 to 25 per cent (according to the various available estimates), unemployment rose to 15 per cent of the industrial workforce, gross investment fell by 27 per cent and wholesale prices by about the same amount. This was the most severe phase of the depression. 1933 marked an improvement in all these indicators but 1934 was again a year of substantial stagnation and high unemployment. It was only with the beginning of 1935 and the policy of heavy deficit spending in preparation for the Abyssinian war that the Italian economy found its way out of the Depression.

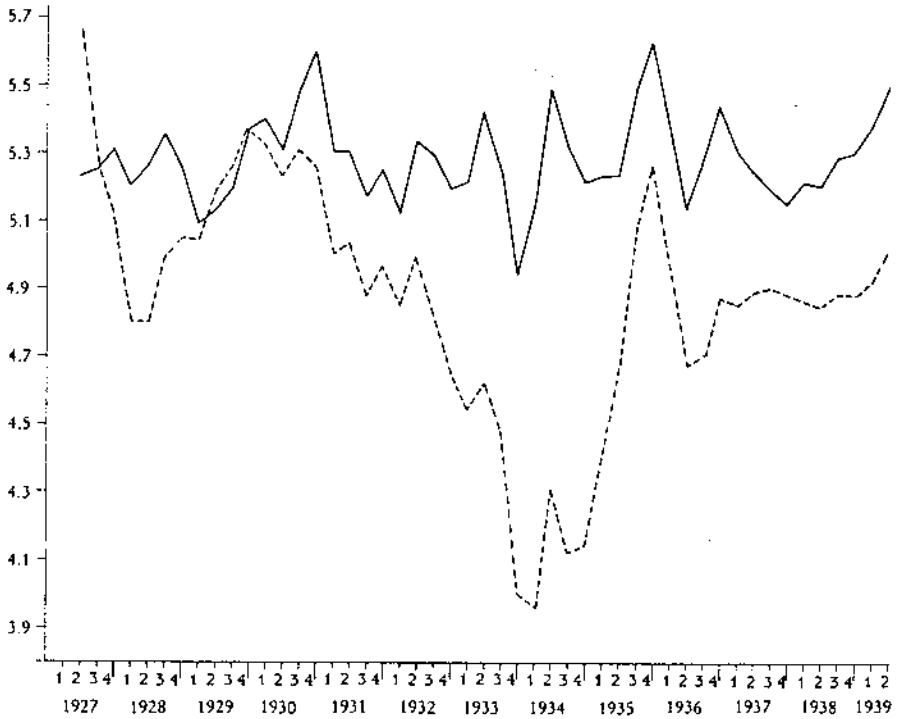
In this situation the monetary and fiscal policy followed by the Government was certainly dominated by the objective of keeping the lira on the gold standard. After September 1931 the overvaluation of the Italian currency was extremely high<sup>22</sup> and could not be supported without some measure of exchange control. It must be said, however, that, given the situation, the Government and the Bank of Italy pursued a monetary policy that was — at least as far as its sign is concerned — of the appropriate (anti-cyclical) kind. There are no clear indications that this was the result of a deliberate action rather than of the lucky mix of several elements: at all events, during the recession the stock of money remained practically stable in nominal terms and rose substantially in real terms, the ratio of money supply to GNP increased quite sharply and short and long-term interest rates were allowed to decline in nominal terms until 1934 (see Figure 1).

Between 1929 and 1933-34 the implicit price deflator of GDP declined every year, on average by about 5 per cent. The question — raised in the United States by the “monetarist” critics of P. Temin<sup>23</sup> — as to whether real *ex ante*

<sup>22</sup> The real exchange rate of the lira (see footnote 21) appreciated by 9 per cent in 1932 over 1931.

<sup>23</sup> Cf. K. BRUNNER (ed.), *The Great Depression Revisited*, M. Nijhoff, Boston, 1981.

Figure 2. NOMINAL (A) AND REAL (B)\*  
LONG TERM INTEREST RATES



\* The estimate of the real rate is based on the following equation:

$$r_n(t) = 5.3 + \sum_{i=0}^{34} a_i p_{t-i}; \quad \sum_{i=0}^{34} a_i = .11$$

$R^2C = .85$        $DW = 1.2$        $SER = .14$       Mean lag: 16 quarters

Source: C. NANNI, *Il tasso 'reale' d'interesse in Italia secondo lo schema di I. Fisher: la crisi degli anni '30 e le tendenze di lungo periodo*, forthcoming.

interest rates did not actually rise instead of falling therefore applies also in the case of Italy. Estimates of Fisher's equation using the yield on consols (*Rendita Italiana 5 per cento*) nonetheless show that this did in fact decline in real terms between end-1929 and end-1933, though much less than in nominal terms (Figure 2). Therefore an explanation *à la* Friedman of the Italian depression does not find any empirical support, whatever its merits in explaining the American cycle.

The banking system taken as an aggregate witnessed an increase in the ratios of both deposits and total lending to GNP, with the former increasing more than the latter. As a matter of fact, the system as a whole did not undergo a serious liquidity and solvency crisis: as we shall see, solvency problems were confined to those banks previously engaged in long-term lending to industry. However, they were crucially important both for the real economy and for the system of financial intermediation.

What went wrong with the "mixed banks"? One must recall: a) that they were the traditional source of finance for those sectors that were most heavily hit by the depression, b) that their assets were largely made up of industrial equities, the price of which was falling rapidly on the stock exchange<sup>24</sup> so that they could not be liquidated, even had they wanted to follow this line of action, c) that their deposits were increasing, this time, at a much lower rate than the average for the banking system, and d) that at the beginning of the period they were all rather heavily indebted abroad on a short-term basis.

What happened early in the depression (i.e. throughout 1930) was a rapid withdrawal of all foreign funds from the major Italian banks and a growth of demand for credit from the private sector four times larger than that of deposits. The huge "mixed banks" and particularly the Banca Commerciale Italiana were at the same time extremely unwilling to cut their lines of credit to their clients and to stop operating on the Stock Exchange to limit the fall of the major industrial shares and of their own as well. In this way they were probably performing a very useful counter-cyclical action but inevitably ran rather quickly into serious liquidity problems.

Apart from those that affected the large "mixed banks", profound changes took place in the banking system as a whole in the longer period 1926-1936. The number of banks fell by 56 per cent, that of branches by 33 per cent and the localities served by 22 per cent. The average size of banks increased considerably in terms of their balance sheets at both current and, *a fortiori*, constant prices. At the same time the long-term downward trend of the degree of

<sup>24</sup> Bachi's general index of share prices fell by 63 per cent between June 1930 and June 1932, the Rosania index fell by 59 per cent over the same period.

concentration of the Italian banking system — as measured by the indices of Herfindahl, Gini and Theil<sup>25</sup> — slowed or, in the case of the savings and cooperative banks, reversed. The number of employees fell by 27 per cent with a consequent sharp increase in productivity. Economies of scale probably made an important contribution to the small decline in bank profits compared with those in industry.<sup>26</sup>

All the different categories of banks recorded a reduction in number. The public authorities took deliberate measures in this direction, which reinforced market pressures for financial concentration. More specifically, a law passed in 1927, the effects of which were particularly felt in 1928-29, required that the smallest savings and pledge banks should be concentrated at the provincial or regional level. In the case of the ordinary credit and cooperative banks the process was most pronounced in the years 1931-33. The difficulties created by the crisis meant that bankruptcies were about five times as frequent as take-overs.<sup>27</sup>

#### *6. Changes in Bank-Industry-State Relations as a Result of the Great Depression*

It is impossible to enter here into the rather complicated technical details of the operations which, between 1931 and 1934, completely reshaped the Italian system of financial intermediation giving it a form that, with minor adjustments, has continued to the present day. We have reconstructed and described these details elsewhere and they need not be repeated here.<sup>28</sup> However, a brief description of the main events and of their significance cannot be dispensed with.

After the summer of 1930 it became clear to the monetary authorities that most of the "mixed banks" were running into serious liquidity problems. After the withdrawal of foreign lines of credit, the banks could only meet their liquidity requirements through advances from the Bank of Italy, which was rather quick to respond as lender of last resort. By 1932 outstanding advances to the three major "mixed banks" — advances that were formally on a very short-term basis, but which had to be renewed indefinitely since the banks could not pay them back — were equivalent to 57 per cent of the currency in circulation.

<sup>25</sup> Cfr. A.M. BISCAINI COTULA and P. CIOCCA, *op. cit.*, Table 10, pp. 116-117.

<sup>26</sup> *Ibid.*, Figure 2, p. 133.

<sup>27</sup> Cfr. BANCA D'ITALIA, *Struttura funzionale e territoriale del sistema bancario italiano, 1936-1974*, Roma, 1977, pp. XXI-XXVI.

<sup>28</sup> Cfr. G. TONIOLO, *Crisi economica e smobilizzo pubblico*, *cit.*

By the end of 1930 it was already clear that the government and the central bank were facing the alternative of letting quite a few of the medium-sized and even of the big banks go bankrupt with unforeseeable consequences for the entire financial system, or of stepping in on a large scale to avoid this, though at a cost that was considered to be very high. There was no question of not choosing the second alternative but the authorities decided to act in such a way as to recreate an acceptable level of liquidity for the entire system (and to avoid any chance of a hidden immobilization of the central bank itself) and lay the foundation of a reform of the entire system aimed at preventing similar liquidity problems in the future.

The existence of an established dictatorship made it possible to undertake all the necessary steps with great rapidity and secrecy. The result of this action was the signing of two agreements between Credito Italiano (February 1931) and Banca Commerciale (October 1931) on the one hand, and the Ministry of Finance and the Bank of Italy, on the other. These agreements contained the following provisions:

- a) the two banks had to sell all their industrial and similar securities to two separate *holding* companies — Sofindit and Sfi — previously created by the banks themselves but to be *de facto* controlled thereafter by the Ministry of Finance and the Bank of Italy;
- b) the latter would make sufficient advances to these *holding* companies to cover the first instalment of the sum to be paid by Sofindit and Sfi to the banks as the price of their industrial portfolio;
- c) this sum was calculated not on the basis of a market price of the securities but with the aim of restoring an acceptable degree of liquidity for the banks;
- d) under these agreements the latter formally committed themselves never to undertake any long-term credit operation in the future nor to hold substantial amounts of industrial securities in their portfolio: this meant the disappearance of the “mixed banks” from the Italian financial scene.

The above measures taken in the depression solved the liquidity problem of the major banks and avoided the suspensions of payments, bank holidays, panics and similar phenomena that characterized the financial crises in Central Europe and the United States. Indeed it was probably the most effective anti-cyclical action undertaken in Italy at the time.

But two other problems remained at the end of 1931 that could not be swept under the carpet. The first was the rather awkward position of the central bank, with over 50 per cent of the outstanding circulation tied up in advances to banks with a large quantity of industrial equities in their portfolios. It became immediately apparent that the shares could not be sold in the market at prices that would allow the holding companies to pay their debts to the Bank of Italy.

It was not the first time in Italian history that the lender of last resort had to shoulder the weight of illiquid and rather dubious assets deriving from the "rescue" of credit houses but this time their amount was dangerously large.

The second problem was created by the "rescue" operation itself: the major industrial firms of the country found themselves cut off almost overnight from their traditional lines of long-term credit at a time when these were desperately needed. The creation in 1931 of a public institution for long-term industrial finance, the Istituto Mobiliare Italiano (IMI), failed to produce, in the short run, any meaningful result owing to the limited amount of resources at its disposal and to the very conservative financial outlook of its first managers.

The solution of both problems was found early in 1933 with the creation of the Istituto per la Ricostruzione Industriale (IRI), a state owned holding company which received from the two holding companies (Sofindit and Sfi) all the industrial equities "inherited" from the "mixed banks". The financial innovation consisted in the fact that IRI was allowed to issue long-term bonds bearing an attractive fixed interest and characterized by being basically equivalent to state bonds (they were guaranteed by the state and enjoyed fiscal privileges similar to those of state bonds).

These characteristics made IRI bonds particularly attractive to the typical Italian saver and in fact their subsequent issues were all well received by the market. In this way, IRI was able to set up a plan for the repayment of the full amount of the Bank of Italy's advances to the "mixed banks" and for the provision of fresh cash to the industrial firms under its control.

This innovation involved a major change in the organization and management of Italian industry and created a basic prerequisite for the reshaping of financial intermediation. The state took over from the banks whatever entrepreneurial role they had previously performed and became actively involved in the management of a large share of Italy's manufacturing, shipping, electric power and communications industries.

The device created on that occasion had little to do with nationalization: for all practical purposes these companies were treated by Italian law as private ones and could act accordingly. The difference was that their majority shareholder was quite often the state, through IRI. And the state could act in the industrial sector through the normal means provided by law to any majority shareholder of any Italian company.

Both the setting up of IRI in January 1933 and its main interventions in the spring and summer of the same year came some months after the upturn in the cycle sometime in the second half of 1932.

The cyclical turnaround cannot, therefore, be attributed to the reforms that were started with the creation of IRI. They nonetheless played an important

role in the subsequent phase of recovery and expansion, which, amidst delays and contradictions, got under way in 1933. IRI's intervention involved its crediting the rehabilitated banks with 12 billion lire: half in connection with the holdings it took over and half simply to cover their losses. The total amount was close to 10 per cent of GNP and considerably more than that resulting from previous "rescue" intervention by state financial agencies — such as those in 1922-24 and 1931-32, neither of which had amounted to 4 per cent of GNP. Moreover, between 1934 and 1937 (when it was put on a permanent footing) IRI advanced a further 2.7 billion to the same banks. These funds were obtained through bond issues and asset sales, rather than from the central bank with a corresponding creation of monetary base.

The scope and scale of IRI's operations were exceptional; not only did they prevent a chain of bankruptcies among large firms and banks but they also had strong expansionary effects at the macro-economic level. Speculative demand for liquid assets declined — together with the financial risk borne by the private sector — more than their supply contracted as a result of IRI's repayment of the central bank with funds raised through the issue of securities.

### *7. The Banking Law and the Permanent Features of the New System*

In 1934 three "conventions" were signed between the state, IRI and the three main former "mixed banks" — Banca Commerciale, Credito Italiano and Banco di Roma — by virtue of which IRI became the majority shareholder of the banks (thus strengthening the overall position of the state at the centre of the Italian system of financial intermediation). The banks again formally agreed not to grant long-term credit and were reorganized as deposit-taking institutions engaged only in short-term lending.

In 1936 a new law reorganized and officially reshaped the Italian banking system. The Banca d'Italia was given a legal status as a public institution with wide powers of supervision over all the banks in the system and with better instruments to act as a modern central bank for the management of monetary policy. This was a timely decision: in October 1936 Italy went off the gold standard, for good, thus making correct currency management both more complicated and more crucial than before. Credit was declared to be a function of public interest. This was not in the sense of replacing an essentially entrepreneurial function by a public utility, but in that of designing a regulatory framework that would enable both publicly and privately owned financial intermediaries to operate in conditions of stability, minimum costs and prices, and allocative efficiency. Apart from paying lip service to the rhetoric of fascist "planning", the new law did not intend to create, through state control of the major banks, new tools of economic policy for the allocation of resources to

specific uses decided by the state. The fundamental aim was to avoid any risk of the big banks being taken over by industrial firms and to prevent excessive concentration in the financial sector: ultimately, to foster competition and to preserve a dialectical relationship between Industry and Finance.

As a necessary condition for the attainment of these goals, the banks have to maximize an objective function in which profit is the main argument and a basic constraint is represented by indifference, or "neutrality", towards the firms and investment projects to be financed, apart from the return and the risk of the loan. Industry and Finance should be separated and they have to follow different behavioural criteria: the specific role of Finance is not to select investment projects, but to choose, on the basis of purely financial considerations, the firms best equipped to realize them.

The existence of two independent judgements on what to produce, and how to produce it, is assumed to improve the allocation of resources. Competition, structural controls and prudential regulation were seen as complementary ways to pursue stability and efficiency. In the same vein, the 1936 banking law provided for a formal distinction between short-term credit (which was called "ordinary credit"), to which all the various deposit-taking banks had to confine themselves, on the one hand, and long-term operations, on the other. The latter had to be performed only by *ad hoc* non-bank financial intermediaries — most, but not all, of which were created and controlled by the state.

As for IRI, it was originally — but never very convincingly — conceived as a temporary institution. The idea was that the state should provide both new finance and new management to "ailing" (it was the word most used at the time) industries, putting them in better shape and waiting for the end of the depression and the recovery of the stock market. This position ignored the fact that in Italy some sectors — such as iron and steel — were traditionally the offspring of close cooperation between banks and the state and that, by eliminating the mixed-banks, they were almost bound to have to be taken over by the state. The idea of selling IRI's industrial equities back to private investors was also inconsistent with the fact that the very creation of IRI had relegated, at least in the short run, the stock market to a role of secondary importance very unlikely to be able to cope with a wave of selling offers without major shocks. Finally, the way Italy climbed out of the depression, through import substitution and military expenditure, made the idea of IRI as a temporary institution conflict with the aims of the economic policy being pursued. In fact, it was not until 1935, when Mussolini gave his orders to prepare to attack Abyssinia, that Italy's industrial production recovered from the depression. A large deficit spending policy concentrating on heavy industry and, quite soon, a strengthening of all the measures to promote import-substituting industries (the so-called "autarky")

program) were the engine of recovery. But at this stage it became clear that the factories crucial for a war effort (such as steelmaking, armaments, shipbuilding, etc.) were controlled by IRI. Far from being requested to get rid of these sectors, the state industrial holding company had to undertake programmes to improve their organization and efficiency.

In 1937 IRI was declared a permanent institution and, to the present day, has been a characteristic feature of the particular blend of Italy's "mixed economy".

As is often the case, more deeply rooted reasons and forces — together with contingent factors — played a role in shaping the new institutional setting. Private capital was simply not prepared to enter most of the productive sectors in which IRI had a majority stake. The risk was too high because of the need to concentrate scarce investible funds into a few projects with long pay-back periods.

It can be argued, on more general grounds, that, at least within a sort of "capitalism without capitalists", the architects of the 1933-37 reforms were quite farsighted.

Publicly controlled firms can be used to achieve economic policy aims; beyond their use for specific and changing purposes, they can guarantee a regular supply of goods and services that private firms are not prepared to produce. In sectors where private firms also operate they can, if managed in accordance with economic criteria, provide valuable competition. A necessary condition for the success of such a system was, and still is, to avoid any confusion between the two aspects: the Italian economy needed new rules for the longer term and, in particular, a public entrepreneurial ability that would be independent of political influence and which, by pursuing efficiency, would supplement and stimulate the private sector. The effective planning of a mixed economy presupposes the setting up of a system of separate resource allocation mechanisms and requires the use of instruments designed to have an indirect influence on the composition of supply.<sup>29</sup>

The aim in 1933-37 was to put the publicly controlled firms and the capital market on a footing that would enable them to operate efficiently independently of the contingent course of economic policy. At the same time, their proper working was intended to make the whole economy more responsive to the fiscal, legislative and administrative tools that the authorities use to influence both private and public economic agents while respecting their "objective functions".

<sup>29</sup> P. CIOCCA, "Disproportionalities, Allocative Mechanisms, and Stagflation", forthcoming in the *Journal of Postkeynesian Economics*.