The experience of Italian banks: from strict controls to full liberalisation

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1. Introduction

Italy's foreign exchange restrictions were already in place soon after the First World War. However, the system of foreign exchange controls applied up to the full liberalisation of capital movements in 1990 was built after the Second World War and operated for almost 50 years. For the sake of simplicity and clarity, reference will be made in general to the post-World War II system and in particular to the experience in the years immediately preceding and following 1990.

In 1990, all capital controls were lifted. Since then, Italy has had a liberalised system fully compliant with European directives and international banking activity has increased at a rapid pace. It would be difficult to compare, in either absolute or relative terms, the dimensions of international banking today with those of more than half a century ago. It would be even more difficult to find homogeneity between the global financial markets of today and the segmented, protected markets of the past. Actually, it can be assumed that the system of foreign exchange restrictions of the past does not fit into the present liberalised world. However, one can look for similarities between the past and the present, with a view to assessing the advantages and disadvantages of a system based on foreign exchange restrictions compared with a fully liberalised one. Yet it is important to stress that in the present circumstances reintroducing restrictions would not produce the same effects as in the past; rather, controls would probably prove to be ineffective or even disruptive.

Section 2 of the paper will provide a presentation of the philosophy and main instruments of foreign exchange controls in Italy, together with a brief chronology of the main developments and measures taken by the Italian authorities. An analysis of a case of a foreign exchange crisis under strict controls (for example, the 1976 foreign exchange crisis) is given in Section 3. An analysis of a case of a foreign exchange crisis under no controls (1992) is illustrated in Section 4, with a view to drawing some lessons on capital account liberalisation, if any. Subsequently, the evolution of the international activities of Italian banks (onshore and offshore) is described, placing the Italian experience in the international framework (Section 5). Some tentative conclusions are drawn in the last section of the paper (Section 6).

2. The system of controls up to 1990

The foreign exchange control system in Italy was built on the principle of "monopoly", according to which all residents (except the Italian Exchange Office - UIC - the monopolist) were prevented from engaging in foreign exchange transactions of any kind. The Italian Exchange Office had the power to grant general/specific authorisations to carry out foreign exchange transactions (under instructions issued by the Ministry for Foreign Trade).

In 1958, the lira was made externally convertible. In the following year, Italian banks were allowed to engage autonomously in foreign exchange transactions and in foreign currency asset/liability management. However, they had to comply with a set of very strict rules (Table 1):

- The balance of foreign currency claims and liabilities, spot and forward, vis-à-vis both residents and non-residents had to be kept close to zero on a daily basis; or the aggregate balance had to be kept within a fixed ceiling (the spot and forward operations ceiling).
- The net position vis-à-vis non-residents (including the above positions and also positions in lire) had to comply with the needs of balance of payments financing, ie positive, negative or neutral according to circumstances.

- The forward net position (the sum of net forward positions vis-à-vis residents and non-residents, aggregated across currencies and maturities) had to be kept within a ceiling fixed on a bank by bank basis (the spot against forward operations ceiling).

Table 1

Mechanism of bank controls

Balance sheet scheme	Assets	Liabilities	Balance
Vis-à-vis non-residents			
fx spot (a)	50	60	–10
fx forward (c)		20	–20
Vis-à-vis residents			
fx spot	40	20	20
fx forward (d)	10		10
A Foreign currencies balance (sum of the above)	**100**	**100**	**0**
Lira net external position (b)	20	20	0
B Net external position (a+b)			**–10**
C Net forward operations balance (c+d)			**–10**

Note: Basic instruments: A - foreign currencies balance (spot and forward operations ceiling); B - net external position; C - net forward operations balance (spot against forward operations ceiling).

In the following years, these three rules became instruments of foreign exchange and monetary policy, managed by the central bank according to its needs. The rules were used:

- to combat speculative attacks against the lira, whether in response to developments in the current account, capital account or politics;
- to enforce a completely risk-averse attitude to taking positions in foreign exchange; and
- to monitor and limit the potential shift from lira claims/liabilities into foreign currency claims/liabilities and thereby to protect the official foreign exchange reserves, to give support to the exchange rate, and to limit domestic credit expansion.

After 1960, some dollar/lira swap arrangements between the Italian Exchange Office and the banks gave some flexibility to the aforementioned foreign exchange position balancing requirement. Given the opportunity provided by the authorities to swap lire for dollars from Italy's foreign reserves, Italian banks developed their own activity at the international level, for instance extending trade credit in dollars. At times, according to the balance of payments needs, the liquidation of these swap arrangements was imposed by the Italian government, together with the adoption of other restrictions on the forward ceiling and, mostly, on the net position vis-à-vis non-residents.

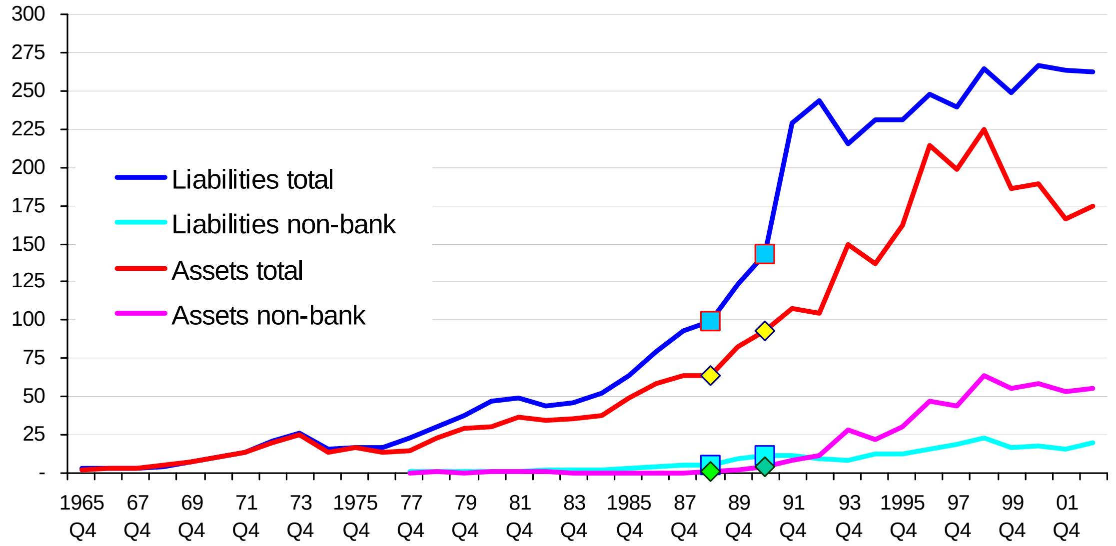
The most "difficult" years were 1973, when a dual exchange rate system (for current and capital account transactions) was introduced, and 1976, when the lira came under heavy speculative attacks. In 1988, the system of capital control was made much more flexible. In 1990, the residual limitations were lifted and a fully liberalised system came into being.

Did the various measures adopted up to 1990 have the desired effect on the banking aggregates? What would have happened in the markets if these measures had not been taken? The answers to questions of this kind are a matter of relativity and, of course, there is no "control solution" to rely on. However, if the ex post empirical evidence is looked at, the impression is that the banking aggregates complied with the rules, but also that international banking developed at a rate below its potential (Graphs 1-4).

Graph 1

Development of main banking aggregates
External positions of banks operating in Italy in all currencies (domestic and foreign)

Billions of US dollars

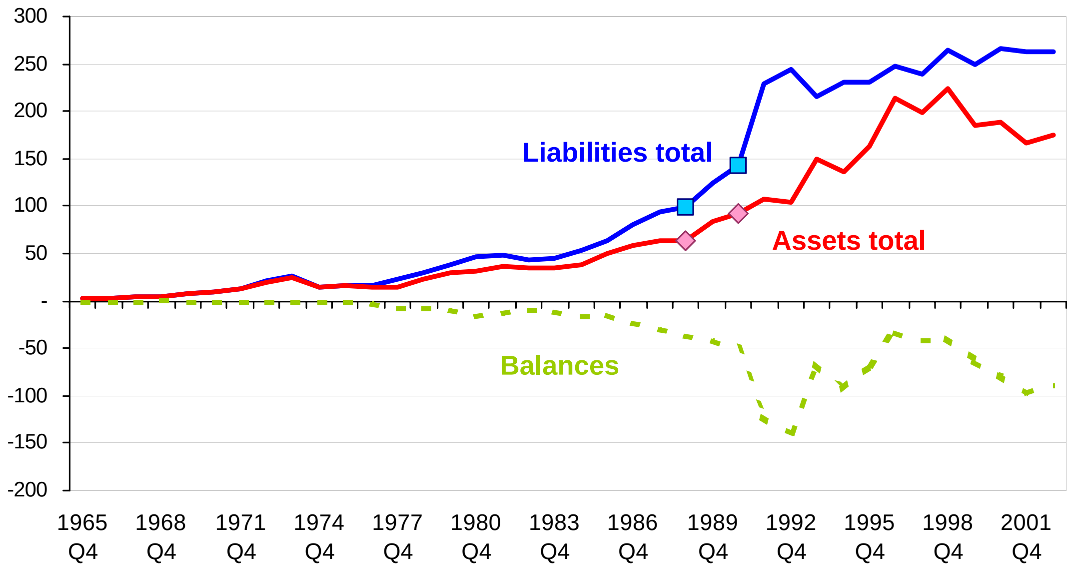


Sources: BIS; Italian Exchange Office.

Graph 2

External positions of banks operating in Italy in all currencies (domestic and foreign)

Billions of US dollars



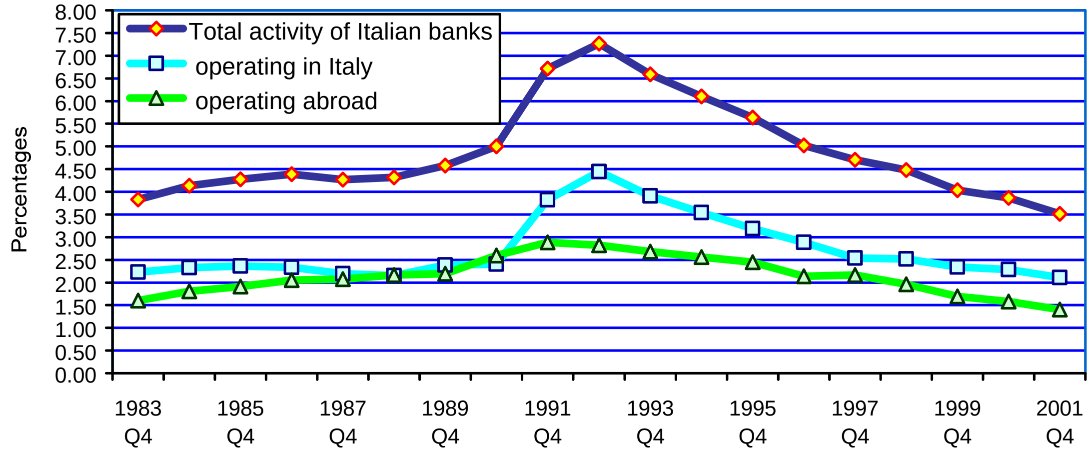
Sources: BIS; Italian Exchange Office.

Graph 3

Share of Italian banks' activities (domestic and foreign) in total activities of BIS reporting banks

Liabilities

Period: December 1983 - December 2001



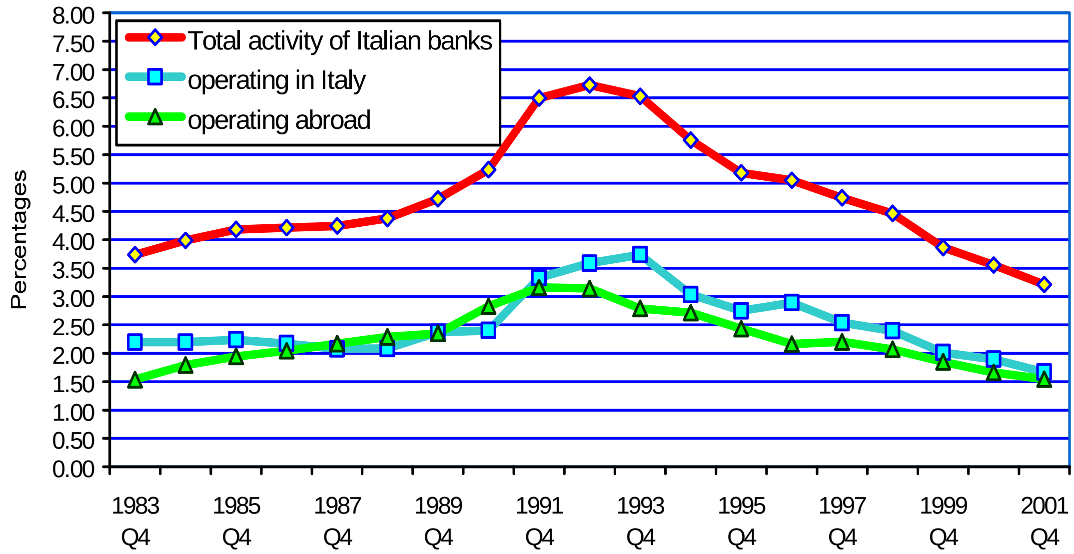
Sources: BIS; Italian Exchange Office.

Graph 4

Share of Italian banks' activities (domestic and foreign) in total activities of BIS reporting banks

Assets

Period: December 1983 - December 2001



Sources: BIS; Italian Exchange Office.

3. International banking: the regulatory experience of 1976

From the second half of 1975, the Italian economy experienced a strong recovery. The recovery very soon became incompatible with the balance of payments constraint. Italian banks' foreign currency debtor positions decreased significantly together with official external reserves.

Italy experienced one of the most serious exchange rate crises at the beginning of 1976. The external convertibility of the lira was suspended between January and February of that year. A tax and a compulsory non-interest bearing deposit on external payments were introduced; the obligation to finance advance payments for imports and export credits in foreign exchange was reinforced; the time limits on residents' foreign currency holdings ("surrender requirements") were shortened; and debtor balances on foreign lira accounts (ie the extension of banking system credit to non-residents) were discouraged (by means of fines).

Italian banks were limited in both their international and domestic activities. The expansion of domestic loans in lire was made subject to a system of ceilings. Banks were prohibited from having creditor foreign currency positions. On the contrary, a debtor foreign currency position was strongly encouraged, inducing the banks to borrow to strengthen official reserves. Foreign claims in lire were frozen. The ceiling on "spot against forward" operations was lowered by 50% (in addition, the use of this ceiling was confined to resident counterparties).

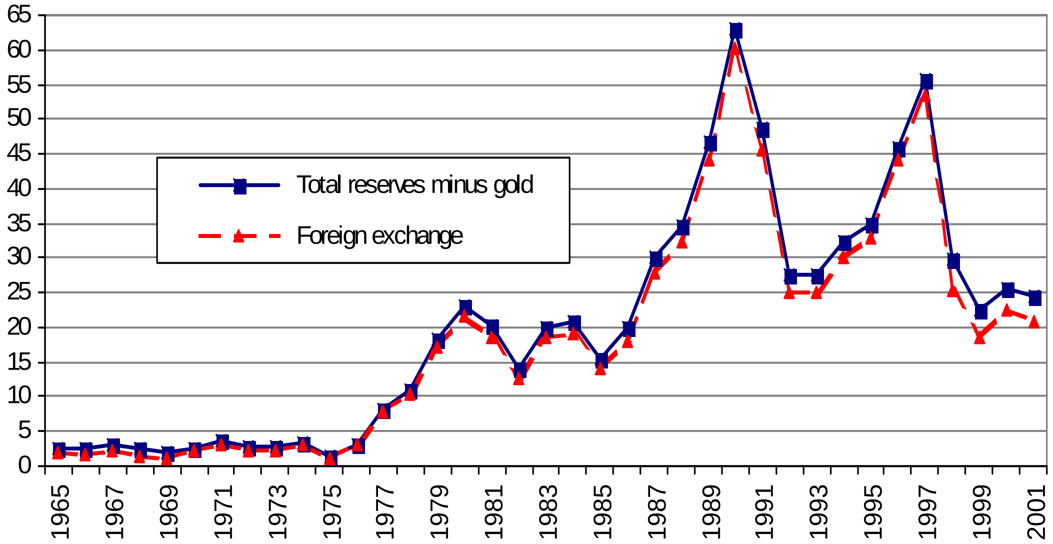
Notwithstanding these measures, the lira depreciated in the foreign exchange market. The nominal effective exchange rate depreciated by 14% in the first three months of 1976 and by 16% on average in 1976 over 1975.

Looking at the development of banking aggregates in 1976 and thereafter, it appears that this set of measures produced the desired results, albeit with the side effect of curbing Italian banks' overall international operations. On the one hand, the net foreign liabilities of the banks went up from around zero to some USD 3 billion at the end of 1976. The figure continued to rise in the following years and reached some USD 15 billion at the beginning of the 1980s. Official foreign exchange reserves were thereby replenished (Graph 5). On the other hand, it can be seen that the overall activity of the banks (claims and liabilities) decreased sharply after peaking in 1973-74, and remained at a relatively low level in the following 3-4 years (see Graphs 1-4).

Graph 5

Official reserves

Billions of US dollars



Sources: BIS; Italian Exchange Office.

As a matter of fact, the regulatory framework of banking activity was conceptually, and indeed also practically, a very efficient and "closed" mechanism. Total (resident and non-resident) foreign currency claims had to be equal to total foreign currency liabilities (by groups of currencies, or even, as in the case of the dollar, by currency). In addition, even if net foreign currency spot claims were matched by forward foreign currency liabilities, the balance (spot against forward) could not exceed a fixed amount. Accordingly, the scope for speculation (coming from domestic sources) against the lira was limited and therefore under control. At the same time, speculation of foreign origins was under control too, because lira funding of non-resident counterparties was restricted.

There was no way for non-resident banks (or non-banks) to build short positions in lire, either directly with Italian banks or indirectly. The expansion of the offshore lira market was ultimately confined by Italian banks' assets, which were the necessary base of international banking in lire. This base was limited, as was its international expansion.

4. International banking: the fully liberalised experience of 1992

The liberalisation process took place gradually. The first important step in this direction was made in 1988. In that year, the compulsory balancing of foreign exchange positions was allowed within a range of ± 5%. Net foreign currency positions vis-à-vis non-residents were allowed to be creditor. Net lira positions vis-à-vis non-residents were dealt with separately. Foreign lira claims could be granted up to the outstanding foreign lira liabilities. Constraints on the foreign currency financing of residents were abolished. However, for monetary policy purposes, a compulsory reserve requirement scheme was adopted for net foreign currency liabilities. The spot against forward operations ceiling was significantly increased. As a result of these measures, the international activity of Italian banks increased at a rapid pace. In the first four months of 1989, the net foreign debtor position rose by some USD 20 billion dollars, or by one third of the stock outstanding at the end of September 1988.

In 1990 all the residual restrictions were lifted. Since then, a fully liberalised institutional setup has been in place. The process of international integration of the Italian economy accelerated. In 1992 the financial transactions turnover in the balance of payments reached 180% of GNP. It had been 90% just two years previously, while in the 1980s it had been constantly below 70%.

The currency crisis in September 1992 affected all European countries. Italy, together with other countries, had to devalue its currency. The banking aggregates bore the bulk of the changes in the demand for and supply of lire in foreign exchange markets and provide an interesting explanation of these developments. In the first eight months of 1992, the net inflow of capital through resident banks was around USD 40 billion. In September of the same year alone, the outflow was more than half that entire amount (USD 21 billion; see Table 2). Foreign exchange reserves decreased at the same pace.

A reconstruction of the main balance sheet items of resident banks at constant exchange rates allows the development of the banks' domestic and foreign positions to be followed. Before September 1992, the banks increased their net foreign currency fund-raising abroad and their foreign currency lending to residents. Their customers apparently did not cover the exchange rate risk in the expectation that the lira would not be devalued, given that uncovered interest rates on foreign currencies were far lower than those on the lira.[1]

As expectations of a depreciation of the lira materialised, the outflow of bank capital came from an increase in external assets and a decline in external liabilities. On the other hand, banks' foreign currency assets vis-à-vis residents decreased while foreign currency liabilities vis-à-vis residents increased. Banks used a large part of the domestic funds raised in September 1992 to reduce their net external liabilities. Overall, they increased their net liabilities in lire and reduced those in foreign currency.

[1] Italian residents were not alone in their short foreign currency, long lira positions. Non-resident portfolio investors had built up positions in Italian government securities in the expectation of lira stability against the Deutsche mark.

The change in the spot position was offset by the net forward foreign currency position. Banks' commitments to deliver foreign currency against lire rose by some USD 14 billion (Table 2).[2] Given this evidence, it is clear that the Italian banks did not take a speculative (short) position in lire. The combined spot and forward positions did not change significantly. However, the official foreign exchange reserves decreased sharply and the lira was devalued.

Table 2

Main banking aggregates, 1992

Flows at constant exchange rates, in billions of US dollars

		June-August	September
External position		**–16**	**21**
in lire	Assets	–1	2
	Liabilities	1	1
in forex	Assets	–6	10
	Liabilities	8	–10
Domestic forex position		**10**	**–6**
	Assets	16	0
	Liabilities	6	6
Domestic lira position		**6**	**–15**
Forward commitments against lire		**–2**	**–14**
	Forex receivable	16	10
	Forex for delivery	18	24
Forex overall position		**–6**	**0**
Memo: Official reserves		*17*	*26*

Note: A positive number on bold lines indicates outflows.

Source: Italian Exchange Office.

One important explanation of the banks' net repayment of external foreign currency liabilities can be found in arbitrage operations in lire. The cost of hedging foreign currency funds (interest plus the forward discount on the lira) exceeded the banks' rate on lira funds, therefore inducing them to repay external foreign currency liabilities. In addition, non-resident banks probably sold lire short, or sold lire forward or borrowed lire to be converted into foreign currency spot, thereby increasing the demand for eurolira and pushing up interest rates. Since Italian banks were the source of lire in the euromarket, the domestic interbank rate also rose, but not as much, therefore determining a differential which further stimulated arbitrage operations in lire.

There was no way to stop this process except by devaluing the lira or increasing domestic interest rates to a level consistent with the expected depreciation, which, in the very short term of, say, a week, would have meant a yield 50 times higher. Fears of a reintroduction of exchange controls might have caused eurolira rates to rise further. The nominal effective exchange rate of the lira depreciated by 13% in the first three months of the crisis, and by 16% 12 months afterwards on a yearly average basis.

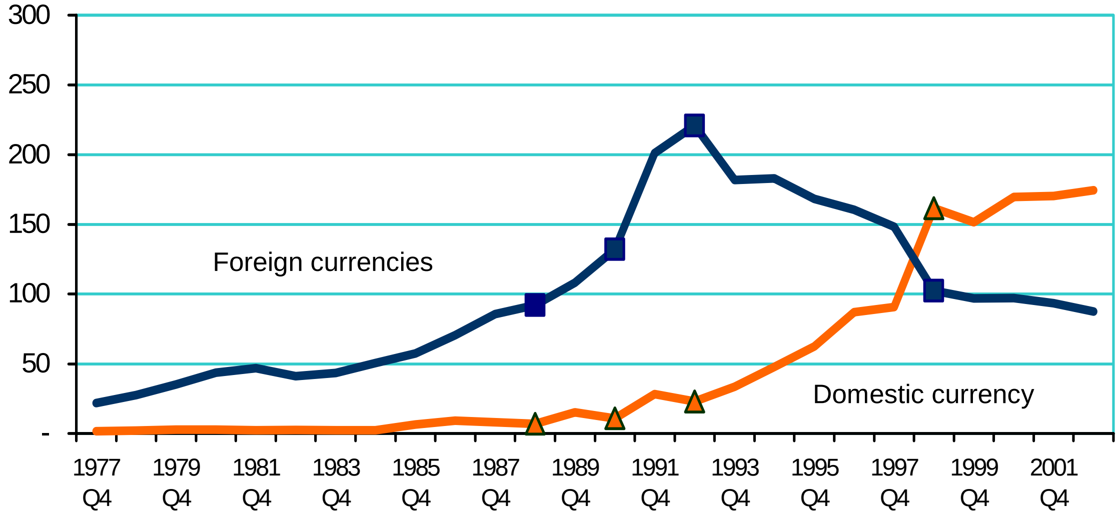
[2] The banks can be seen as accommodating the demand for forward cover on short foreign currency positions of residents or on long lira positions of non-residents.

Graph 6

Banking aggregates, historical series from 1977 stocks outstanding

External liabilities of banks operating in Italy in domestic and foreign currencies

Billions of US dollars

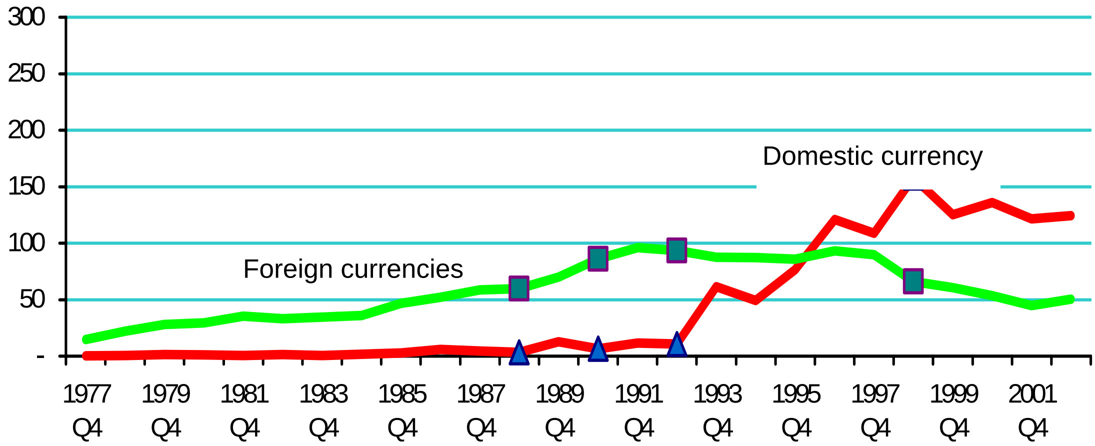


Sources: BIS; Italian Exchange Office.

Graph 7

External assets of banks operating in Italy in domestic and foreign currencies

Billions of US dollars

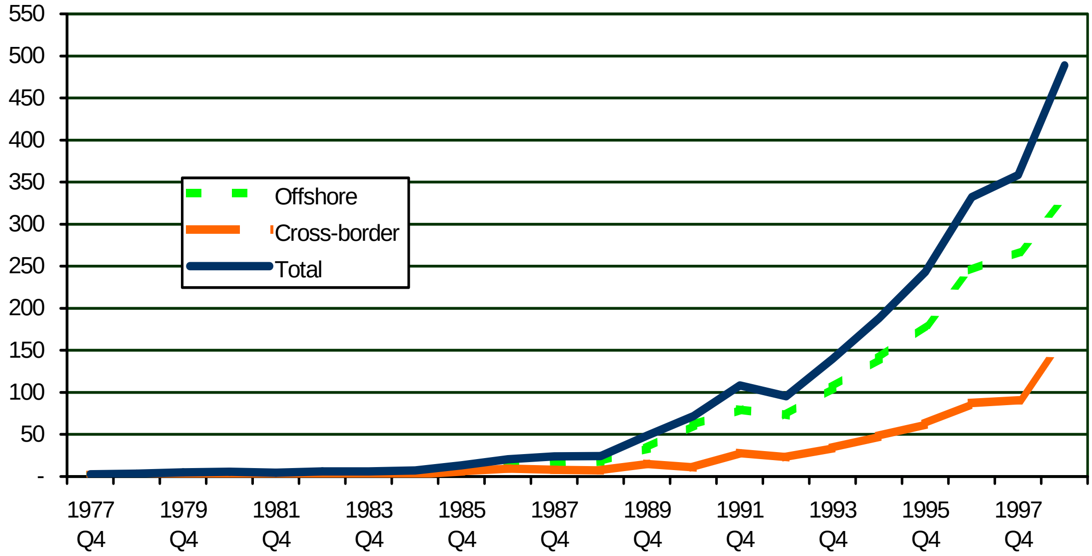


Sources: BIS; Italian Exchange Office.

Graph 8

Lira global market (offshore + cross-border) liabilities

Billions of US dollars

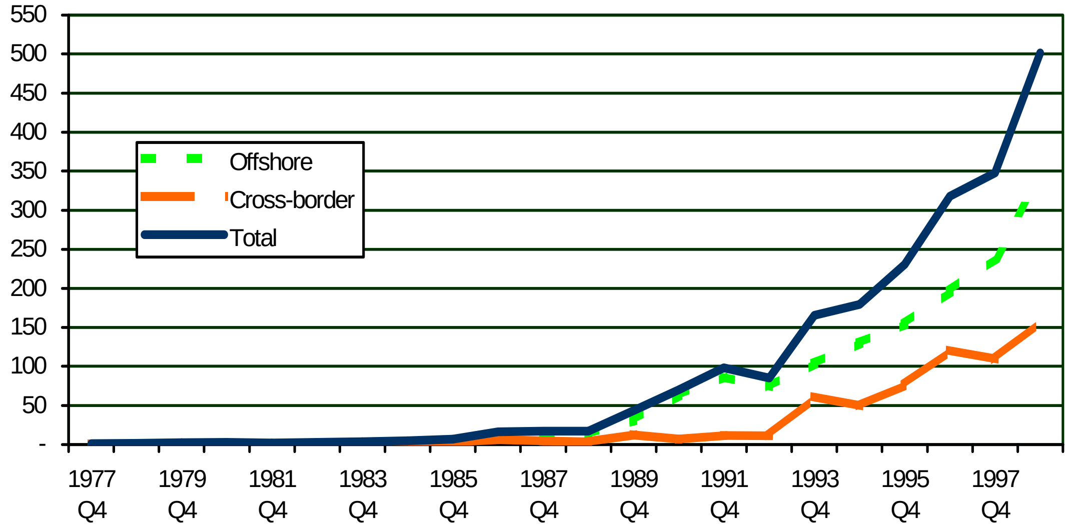


Sources: BIS; Italian Exchange Office.

Graph 9

Lira global market (offshore + cross-border) assets

Billions of US dollars

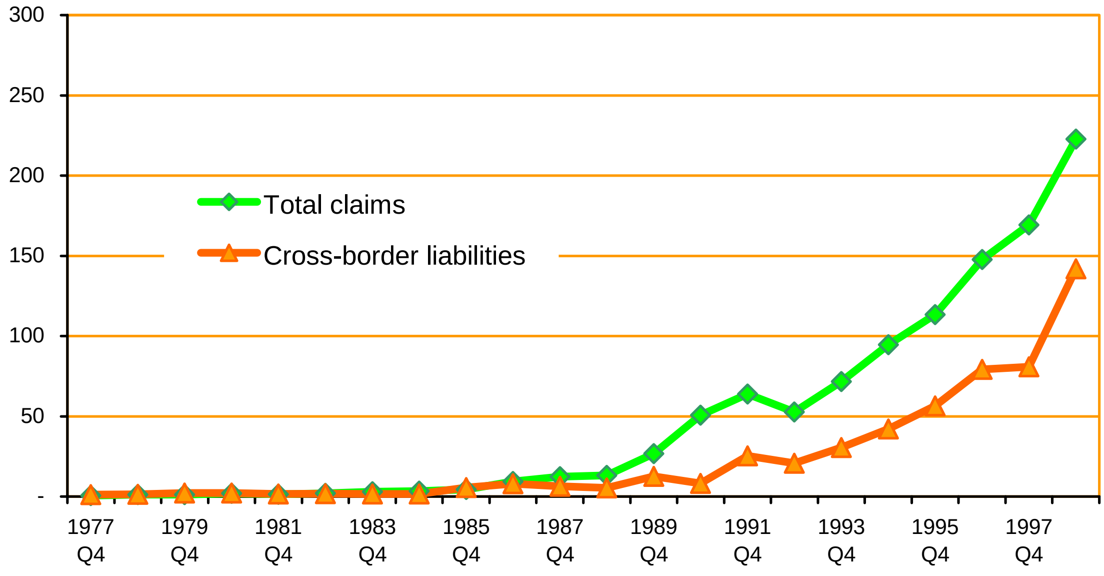


Sources: BIS; Italian Exchange Office.

Graph 10

Lira interbank market: Italian banks' cross-border liabilities and BIS reporting banks' total claims

Billions of US dollars

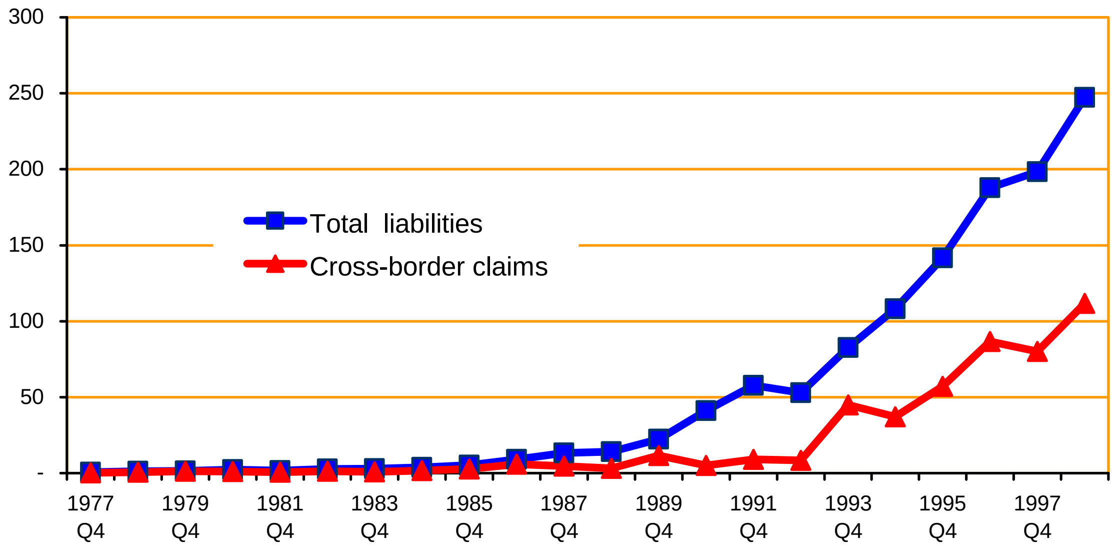


Sources: BIS; Italian Exchange Office.

Graph 11

Lira interbank market: Italian banks' cross-border assets and BIS reporting banks' total liabilities

Billions of US dollars



Sources: BIS; Italian Exchange Office.

5. International banking in the 1990s

In the years which followed the 1992 crisis, Italian banks experienced significant rates of growth in their international business, albeit in line with the growth of banks in other countries (Graphs 6-11). Their positions grew, either spot, forward, domestic or external, with rather differentiated patterns. However, the main characteristic of their behaviour appears to be risk aversion.

With a view to monitoring the development of the demand for and supply of foreign currencies and of the source for funding currency and external positions, the Italian Exchange Office introduced a system of daily reporting which was not meant to reintroduce controls but rather to enrich the statistical evidence and therefore enhance the knowledge of the workings of the foreign exchange markets.

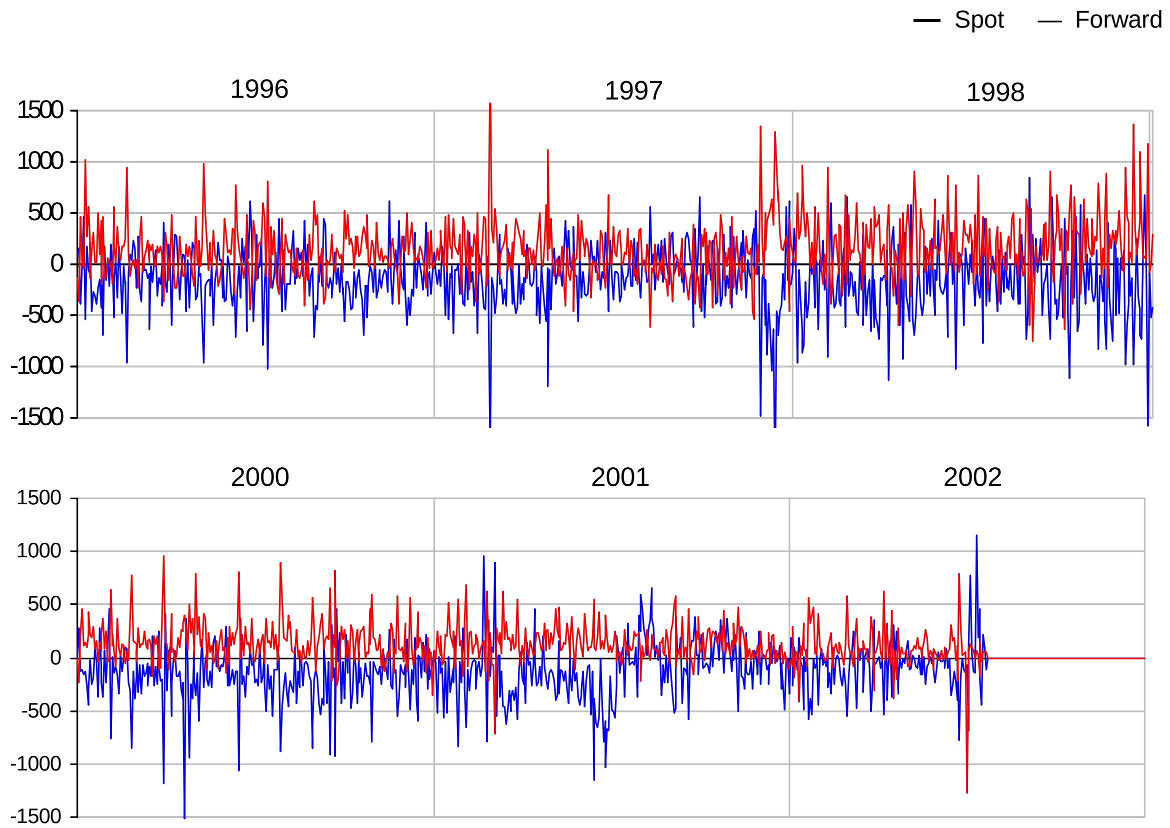
From 1996 up to 2002 a large quantity of high-frequency data was collected. A rapid look at Graphs 12-15 provides an interesting picture of the present international banking scenario. First of all, the overall foreign exchange position is almost constantly balanced. The spot pluses or minuses are systematically offset by opposite values in the forward section of the banks' activity. At the same time, one can see that net claims/liabilities vis-à-vis non-residents quite often find compensating positions vis-à-vis residents. Lira lending/borrowing to/from non-residents (euro since 1999) developed faster than that of foreign currency lending/borrowing.

Graph 12

Banking aggregates, daily turnover from 1996 onwards

Foreign exchange daily net position

Millions of euros

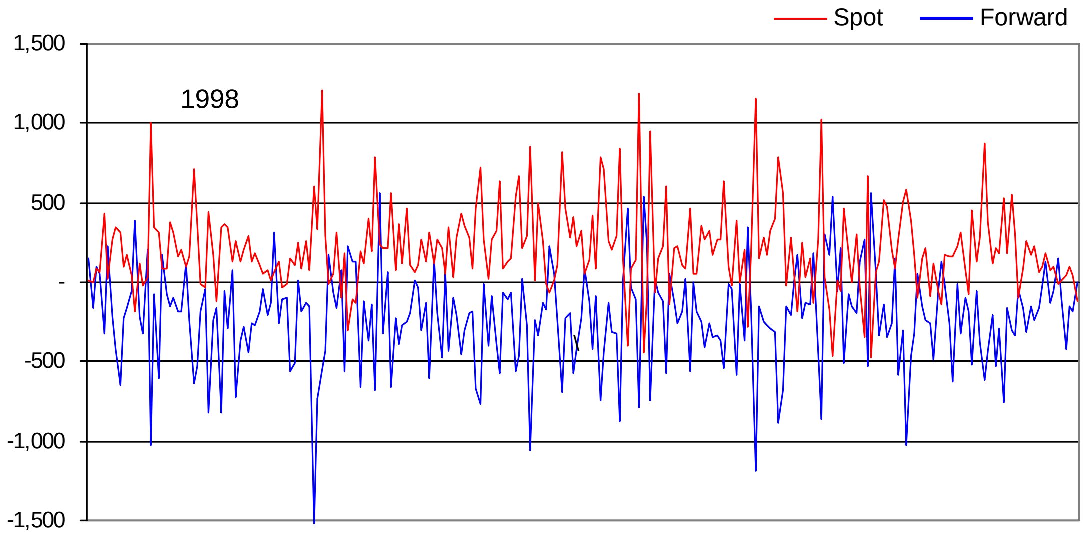


Source: Italian Exchange Office.

Graph 13

Foreign exchange daily net position

Millions of euros

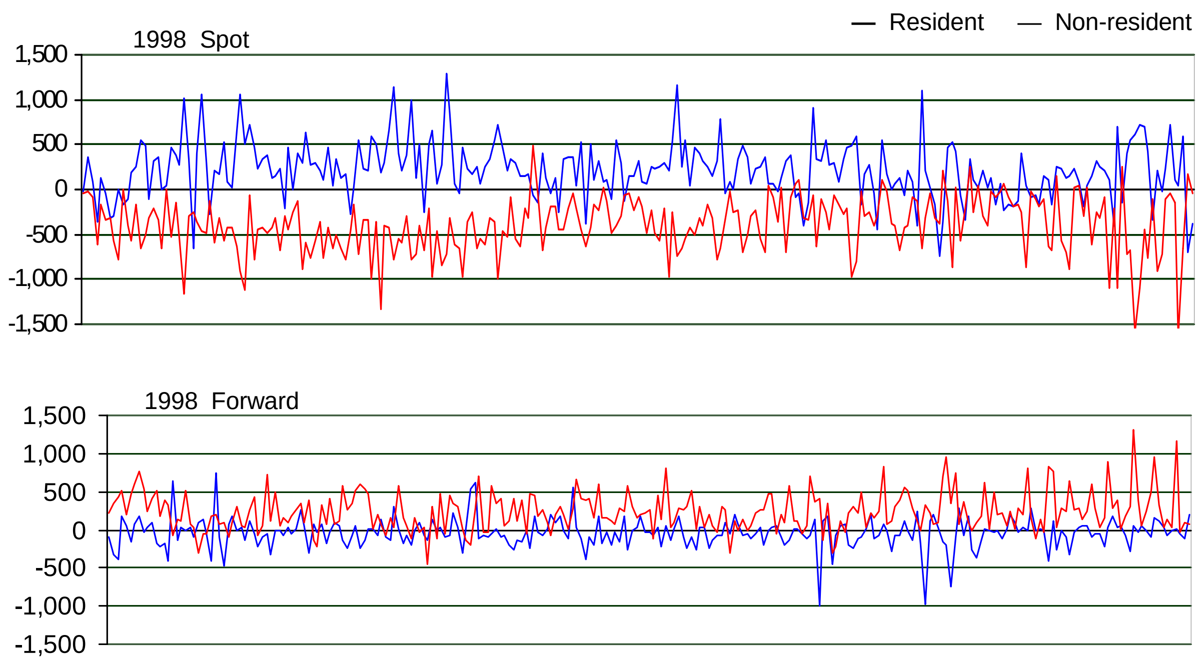


Source: Italian Exchange Office.

Graph 14

Foreign exchange daily net position

Millions of euros



Source: Italian Exchange Office.