

# Determinants and Trends of Italian Financial Policy

## 1. Introduction

Italian financial policy in the 'eighties has been aimed mainly at improving the relevant segments and achieving a better mix of the whole range of instruments and intermediaries, as might be expected in a country characterized mainly by typical (*i.e.* standard) instruments and specialized intermediaries. Other two trends have been much less to the fore than in the rest of the world — privatization and deregulation. The former is still the text for various sermons and forms the testing ground for one or two major state holding companies rather than an economic policy objective. Deregulation has hardly affected credit intermediaries, and has still to make its presence felt in the stock exchange. In the financial intermediation sector, a process of regulation and tightening up of supervision is under way.

The developments promoting the enrichment of instruments and intermediaries show a moderate inclination towards innovation, which in turn is produced by the marked disequilibrium of the economy, the steps taken by economic policy to control and redress it, the drive by the economic agents to expand the margins for manoeuvre left by the network of controls and the reactions of the administrative and fiscal authorities and of the legislator. Italy therefore also confirms the paradigm which prefers to regard the process of financial innovation as closely linked to the level of constriction imposed by the authorities. Obviously it is an open question whether this type of innovation helps to improve efficiency and wellbeing by meeting a real need, or whether its "artificial" origin merely gives rise to a sterile tug-of-war between the market and the authorities. In both cases, however, it is the role of the market which is confirmed. Over time, the market is the only real judge in capitalistic economies of the soundness of an instrument, of the vitality of an intermediary or of the effectiveness of a system of regula-

tions. This obviously also applies to the more modern conception of financial innovation which sees it as linked to the manipulation of risk, to ensure that demand for financial assets is satisfied in a more efficient way.

## 2. Economic circumstances and macro-economic policies

Let us take a quick look at economic conditions and policies of control in order to outline the context in which financial innovation became interwoven with the response of the authorities and/or the market. The phenomenon for which the 'seventies will be remembered is unquestionably inflation which, though common to all industrialized economies, has proved more prolonged and difficult to curb in Italy than in other countries. The retail price increased by an average of 12.3 per cent a year from 1975 to 1979, and by 15 per cent from 1980 to 1985.

The consequence, but also the original and concomitant cause, of the strong inflationary pressure in Italy was, and still is, public finance. If we measure the disequilibrium in the terms most relevant to the present analysis, we will find that the Government sector borrowing requirement as a proportion of GDP rose from 9.8 per cent in the period 1970-79 to 14.9 per cent in 1980-85. The combination of the two phenomena, inflation and the increase in Treasury financing requirements, transmitted its high levels and variability to interest rates, which were driven up to high and positive values in real terms by monetary policy and public debt management. By the end of 1979, six-month Treasury bills yielded 15.7 per cent, and two years later the rate rose as high as 21.4 per cent, falling to 13.1 in 1985. (In October 1986, net of tax, the figure was 9.67 per cent.) At the same dates, the yield of Treasury certificates of deposit was 14 per cent, 22.3 and 14.49 per cent. (In October 1986, still net of the recently imposed tax, the figure was 10.48.)

These are the variables which, together with the incentives offered from time to time by the authorities, have mainly contributed to the promotion of financial innovation in Italy. They therefore call for a closer study, specially with reference to business firms, before we tackle the analysis of financial innovation and of the policy which governed it.

It should be emphasized that it is macro-economic conduct which conditioned financial developments. For the types of instruments resorted to, also, it was monetary policy, inclusive of public debt management, which led to the main innovative thrusts and counterthrusts, and to this policy we will devote closer attention.

2.1. The inflationary cycle had an extensive and profound influence on corporations' productive and financial structures, although in different terms and with different results, depending on the size of the concerns and on whether they belonged to the public or the private sector.

The reaction of the Italian productive system to the combined effects of the wage explosions starting at the end of the 'sixties and of the double oil shock in the 'seventies was immediate in the case of medium-sized and small firms, which were the first to effect significant innovations in their productive processes, with substantial gains in terms of productivity and quality. Their penetration of foreign markets was, on the one hand, a decisive factor in keeping down the balance-of-trade deficit, and, on the other, an effective one in achieving positive business outturns. The rapid adaptability to market changes, linked with the operators' inventiveness, made it possible for medium and small firms to play a leading role in the 'seventies, despite the general difficulties which were then weighing on industry.

For the large firms, productivity and profits had fallen in the first half of the 'seventies as a result of the adoption of production and investment programmes which, in various sectors, proved incompatible with the new relative prices of labour and energy. Initially, the efforts to restructure undertaken towards the end of the decade were mainly by large private corporations, since public-sector concerns were more subject to socio-political constraints. After the turning point in the autumn of 1980, there was a change in the trade union climate. From 1983 on, industrial profitability revived as the result of a profound revision of organizational patterns and productive structures. This was achieved not only by having temporarily redundant workers paid by the official wages supplementation fund and by lowering social security contributions, without limiting the corresponding benefits, but also by substantial investments and greater automation.

This adjustment was matched by a similar development in financing, with a marked reduction in the share of bank indebtedness in the overall financial resources employed, partly induced by the increase in

real rates of interest, and therefore a better balance in the maturities structure of indebtedness.

In the 'seventies, negative real interest rates had facilitated recourse by firms to bank credit; the reduced profitability had led to a fall in self-financing; the limited stock exchange market and disincentive tax provisions had acted as a brake on recourse to equity issues. We need only give a few figures to illustrate the deterioration during these years in the corporations' financial accounts. In 1974, the corporations' own funds had fallen to 13 per cent (as against 20 per cent for the years 1968-69) of the funds administered, and on an average own funds did not exceed 14 per cent during the period 1975-79. Short-term indebtedness had risen to about 38 per cent in the years 1974-79 (as against 30 per cent in the previous four years) of total external financing, while medium- and long-term indebtedness rose to 27 per cent (as against 25). Self-financing, which in the 'sixties had accounted on an average for over 50 per cent of all sources, whether internal or external, had fallen to about 40 per cent. Net issues of shares from 1975 to 1980 had on an average stabilized at 10 per cent of total financing to the private sector including share issues themselves.

Firms' excessive commitments to the credit system, at a time when it seemed doubtful whether they could service the loans owing to their difficulties in paying their way, led Carli, at that time Governor of the Bank of Italy, to bring the question of firms' financial restructuring to the attention of political and economic circles in the first half of the 'seventies. His — deliberately provocative — proposal was that part of their debtor positions *vis-à-vis* the banks should be transformed into shares for amounts corresponding to certain bank loss provisions, or written off by reducing those provisions to the same extent. Law 787, passed in 1978, which provided for the formation of consortia between credit institutions and for the consolidation of certain debts, and also the "Prodi Law", constituted the legislators' response, however partial and tardy, to Carli's concern.

The lively debate at that time brought out the inefficiencies of the system, the most obvious ones being those due to the extensive loans granted on concessionary terms to a wide variety of sectors, as well as the need to elaborate a more diversified and less skewed system for financing in which risk capital would again start flowing to firms and strengthen their capital base. While the ratio of net share issues to total financing granted to the private sector in the five years from 1981 to 1985 settled at around 20 per cent on an average, indebtedness in the

three years 1983-85 reverted to within healthy limits, and even fell below the levels of the last years of the 'sixties.

These favourable developments were possible thanks to an incomes policy which kept down wage increases in nominal and real terms and which led to the revision of the law governing the sliding scale mechanism, both of which factors helped to moderate the inflationary expectations that were at the root of the wages/prices spiral. An incomes policy alone would not have been sufficient, but it was complementary to a monetary policy which became less and less accommodative.

2.2 The disequilibria in the Italian economy beginning in the first half of the 'seventies, like those in the other OECD countries, took the form of a high level of inflation, a declining trend in the rate of growth, the expansion of the public-sector borrowing requirement, the appearance and disappearance of large external deficits, the fall in productive investments and the excessive indebtedness incurred by firms. All these were tackled by a complex strategy, which, especially in the last five years, has spanned different fronts.

Since budget policy, which is less able to react quickly because of the decision-making mechanism, was itself the cause of the disequilibria, the most important instrument deployed in the battle against inflation was monetary policy. The very size of the disequilibria, their non-financial nature, the impossibility of deciding *a priori* on the real rate of interest sufficient to produce the desired adjustment, the crisis in the fixed-rate security market, and lastly the need to produce quick and possibly precise results were the main considerations which induced the authorities to decide in favour of an approach geared to quantitative regulation. Moreover, the conviction that the Italian financial structure and the recurring external deficit on current account made it inadvisable to adopt controls focusing on money, inclined the authorities to identify total domestic credit as the main intermediate objective, to be obtained by recourse to direct constraints on the liabilities side, but especially on the assets side of the banks' balance sheet.

Compulsory reserves, which were revised in 1975, led to a gradual tightening of the average coefficient which, by the end of 1985, was as high as 19.7 per cent. In 1973 a ceiling on loans had been applied for the first time, and this had remained in force almost without interruption till June 1983. Lastly, in order to influence the distribution of financing flows between loans and private bonds, a portfolio constraint was introduced protecting the latter, with the declared object of providing

funds for special credit institutions, which had been crowded out from the collection of funds by the savers' increased liquidity preference.

Moreover, monetary policy, especially when the disequilibria were most serious, acted not only via the regulation of the flow of bank funds from abroad and of the terms for the settlement of imports and exports, but also via the imposition (on three occasions: in 1974, 1976 and 1981) of an advance temporary deposit on imports, a tax on the sale of foreign exchange (for a short period in 1976), and, in 1973, a non-interest bearing deposit on investments abroad, specifically those in financial assets and real estate. Only in recent times was the last item reduced, by stages, from 50 per cent to the present level of 15 per cent for private operators, and partially abolished for investment funds.

The last few years have witnessed the gradual abandonment of quantitative controls based on direct instruments, since they detract from the efficiency and effectiveness of the markets controlled and stimulate the creation of other markets which can, at least for a time, evade the restrictions. But the authorities have shown that the abolition of these controls does not imply a decision not to resort to this type of instrument. It is because of the precision and rapidity with which it can operate that, in the first half of 1986, the limit on the expansion of bank loans in lire was temporarily revived. The spread of expectations of a realignment of the lira in the European Monetary System had induced economic agents to reduce their indebtedness in foreign exchange towards the end of 1985, and to increase their debts in lire.

Since the point at which total domestic credit was replaced, as the main intermediate target, by credit to the economy and money (M2), the preference has been more and more for a method of indirect control, as the disequilibria became less marked, distortions increased, and the efficacy of the instruments diminished. Hence, there has been a return to the practice of giving more freedom to the money, credit and foreign exchange markets by regulating monetary base and interest rates. In particular, these rates have been brought back to high and positive levels in real terms, and this has made it possible to ensure that the rapidly expanding financial wealth, caused by the public-sector deficit, remains sustainable.

Strong in the experience of the 'seventies, exchange rate policy has singled out its link with the EMS as the main point of reference. When the inflation differentials within the European Community threatened to undermine Italian firms' price competitiveness, realignments have made it possible to recover a margin of manoeuvre. Care has been taken

not to offset entirely, by such exchange rate adjustments, the deterioration of domestic costs and prices *vis-à-vis* those of foreign countries — with the declared intention of using the inevitable strains to put pressure on firms to make structural changes and reduce costs.

In the process of adjusting public finances, the greatest success has been achieved in the field of the public debt. The policy adopted shows three specific stages: the 1975 reform of the mechanisms for auctioning off the short-term Treasury bills, the "divorce" between the Treasury and the Bank of Italy, and the introduction of new instruments.

In order to ensure more effective monetary control, it was essential to create an efficient money market. This led to innovations in the auction mechanism. The central bank was thus given a role as a participant rather than as a purchaser of last resort for securities which found no taker, as was the case from 1962; therefore, the central bank was given the possibility of helping to determine the prices of the bills. Since that year, the short-term Treasury bill market has expanded and strengthened. When the yields offered became positive in real terms, the market made it possible to ensure the non-monetary financing of the Treasury, since final demand was generated by firms and, above all, households.

This development became completely perceptible with the "divorce" between the Treasury and the central bank, which is to say, by the lifting in 1982 of the undertaking by the Bank of Italy, on the basis of a decision by the Interministerial Committee on Credit and Savings in 1975, to meet the Government borrowing requirement by purchasing Treasury paper. In this way, the Bank of Italy recovered its autonomy as regards the regulation of money and credit; and the principle was laid down once again that the Treasury should seek on the market the funds to enable it to meet its cash needs.

To this end, steps were also taken to introduce new financial instruments such as Treasury Certificates of Credit, Treasury Certificates in ECUs, Real Treasury Certificates (indexed to the GDP deflator) and Convertible Treasury Certificates of Credit, the yields and characteristics of which have been studied with a view to meeting both savers' needs at a time when the prevailing factor was the high and volatile inflation, and the necessity for the Treasury, faced with a growing requirement which exceeded 100 trillion lire in 1985, to manage its indebtedness with less of a strain. As a result, the gradual lengthening of maturities on terms which, over time, would not prove disastrous for the Treasury has become the main objective of public debt management.

With the appearance of disinflation, greater recourse has been had to fixed-rate issues (with the revival of Treasury bonds — an instrument familiar to the Italian public). Between 1980 and 1983, a profound change took place in the composition of new issues of short-term and medium-term securities. The share of Treasury bills fell from 84 per cent to 12 per cent of the total flow of new issues. In 1980, the average life of the public debt was barely over a year; at the end of 1983, it rose to just over eighteen months. At present, it is about four years.

The piling up of the budget deficits has put the public debt, which, from 1970 to the present time has shot up from 25 per cent of GDP to over 100 per cent, at the centre of the debate on Italy's financial policy. It may, however, be remarked that the problem is not whether there is a critical level of that debt, but whether the position can be sustained unless budget policy becomes aware of the dangers of the accumulation of public-sector liabilities, not only for the servicing of the debt, but also for the composition of the portfolios of those holding it.

2.3 To sum up, the main lesson to be drawn from the economic policy pursued in the last five to ten years is the increasing restoration of the role of the market in the allocation, not only of real, but also financial resources, and of the price system as the mechanism signalling the relative scarcities and the public's preferences. If we confine our attention to the financial aspects, that emerges clearly not only from the course followed by monetary policy, but also from the reduced emphasis on soft credit for investments. The "cathedrals in the desert" which concessionary credit helped to erect in the 'seventies have not yet been forgotten, but continue to weigh on the public finances. In addition, there is greater awareness of the damage which a purely administrative approach can cause within any financial intermediary which, if it is to carry out its objective function correctly, must be able to judge the risks and returns of an investment and be free from any conditioning factors.

Another field in which the importance of the market has barely begun to emerge and which still needs to be confirmed is the liberalization of capital movements. This seems to be one of the basic preconditions for complete economic integration, without which the European Economic Community would remain predominantly a free trade area. Law 599 (1986), which relaxed the rules governing Italian residents' relations with foreign counterparts and finally establishes the principle that everything not expressly forbidden is permissible, forms

part of the renewed drive towards greater freedom, which has left its stamp on other measures adopted recently. These are all designed to achieve the target — still a distant one, however — of complete freedom for capital movements, a pledge which Italy has formally reaffirmed at the highest policy making level of the EEC. These measures of liberalization cannot but run parallel with those for putting the economy and finances of the country on a sound basis. The elimination of the current budget deficit net of interest will in the end become a necessity dictated also by international considerations.

Although the Italian economy is chafing at the bit to secure complete integration in the international financial market, the need for stability in the system as a whole makes it essential to proceed with determination, but without needless and dangerous haste. Complete freedom of capital movements will force Italy not only to follow economic policies diverging less and less from those of the leading members of the Community, but will compel the Italian financial system to keep bringing itself up to date, in order to compete successfully with foreign financial intermediaries in attracting funds, even after the stage in which Italian savers adjust their portfolios between assets in foreign exchange and those in lire. And the faint response on the part of the Italian banking world to innovative thrusts in the field of financial instruments gives ground for a certain degree of concern as regards the stability of the system.

### 3. Financial innovation in Italy

Before we tackle the diversified phenomenology of financial innovation, it would appear to be useful to examine the composition of the total assets and liabilities of the private sector, which includes not only households but also non-financial firms. The choice of this aggregate instead of households alone (the ultimate owners of all forms of wealth) has the disadvantage of eliminating every type of share and participation securities issued by companies, but the advantage of avoiding the valuation problems both of the firms whose equities are traded on a market and of those not listed or listable.

From Table 1 showing total financial liabilities of the private sector, it will be seen that, between 1975 and 1985, the weight of loans

TABLE 1

STOCK OF TOTAL FINANCIAL LIABILITIES OF THE PRIVATE SECTOR  
(As a percentage)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Bank loans <sup>1</sup>											
in lire <sup>1</sup>	52.5	53.3	50.9	52.1	53.9	51.7	48.6	46.8	47.4	47.1	51.4
in foreign exchange	0.9	2.7	5.0	3.8	4.2	6.8	6.1	5.6	6.4	7.9	5.6
Bank acceptances	—	—	—	—	0.4	1.2	1.4	0.9	0.5	0.2	0.1
Loans by special credit institutions <sup>2</sup>											
short-term	1.2	1.2	1.3	1.7	2.0	2.3	2.7	2.9	2.9	3.4	3.4
long-term	31.8	30.6	29.4	28.6	26.0	24.1	23.8	24.2	22.7	21.7	21.3
Factoring <sup>3</sup>	—	0.4	0.8	0.9	1.0	0.9	1.0	1.1	1.1	1.4	1.4
Leasing	—	—	0.1	0.1	0.2	0.2	0.3	0.6	0.7	0.9	1.2
Indexed bonds	1.0	1.5	2.2	2.7	2.6	2.3	2.3	3.5	3.6	3.9	5.6
Other bonds	8.4	7.5	6.1	5.4	4.6	3.7	3.1	2.7	2.5	1.9	—
Foreign liabilities	4.2	2.8	4.2	4.7	5.1	6.8	10.7	11.7	12.2	11.6	10.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

<sup>1</sup> Including bad debts and excluding loans to leasing and factoring companies. The data are adjusted by an estimate of the effects of the accounting devices used by the banks for the periods when the ceiling was in force.

<sup>2</sup> Excluding loans to leasing and factoring companies.

<sup>3</sup> The data on loans effected via leasing and factoring companies refer to existing contracts at the value of the goods leased, net of the proportion of capital implicit in the instalments already collected.

Source: C. CARANZA e C. COTTARELLI, *Financial Innovation in Italy: a Lapsided Process*, Bank of Italy, May 1986. The updating of the data for 1985 by the authors is gratefully acknowledged.

in lire has remained essentially constant at around 52 per cent, even if, after 1980 and up to 1984, it fell below 50 per cent as a result of a more stringent monetary policy; loans in foreign exchange appear to have stabilized at higher values after 1980, presumably for the same reason, supplemented by the lower exchange rate risk as a result of Italy's membership of the European Monetary System. In the case of specialized credit institutions, there is a clear upward trend in short-term loans and a much more marked tendency for medium-term ones to fall. Both reflect, not only the identity crisis of the institutions, but also the end of the support provided by the portfolio constraint and by concessionary credit, to which in recent years we may add, as a result of the shortening of the duration of the loans, the discrimination constituted by the flat tax on the amount of the loan. The same may be said of bonds. Indexed bonds seem to be progressing steadily, while the others, presumably almost all of them fixed-rate ones, fell from 8.4 per cent in 1975 to under 2 per cent at the end of the period. Current and expected inflation fully explain this development. Lastly, foreign liabilities went up, rising to a maximum of 12.2 per cent in 1983 for the same reasons as those justifying the increase in foreign exchange loans.

New forms such as bank acceptances, leasing and factoring, which were non-existent in 1975, make up in all only 2.7 per cent of total liabilities in 1985. If indexed bonds are also included, the figure rises from 1 per cent to under 7 per cent in that period. A first provisional conclusion to be drawn from these data is that inflation, the budget deficit and the volatility of interest rates, far from replacing old instruments to a large extent with new ones, have exerted their main influence on the composition of traditional financial assets.

If we examine Table 2, showing the stock of total financial assets, we obtain much the same information. Money (notes, coins and deposits) is affected by a markedly negative trend which emerges as soon as the real rates of interest become strongly positive. This holds both for bank deposits and for postal savings. For coins and notes, the drop is more marked, since it is part of a historical trend. The specialized credit institutions' certificates of credit have remained stationary. Those of the banks have increased from 1983, but at lower rates than expected. Short-term Treasury bills (BOT) and certificates (CCT) appear to be the only assets showing a substantial expansion. They were absent at the beginning of the period, and at the end each of them constitute 14 per cent of the total, having replaced monetary assets in portfolios. The other bonds show a downward trend, presumably

TABLE 2

STOCK OF TOTAL FINANCIAL ASSETS OF THE PRIVATE SECTOR  
(As a percentage)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Notes and coins	8.7	8.2	7.7	7.3	6.8	6.8	6.7	6.2	5.8	5.3	4.9
Bank deposits	66.5	67.7	69.0	67.5	66.1	64.5	60.9	60.0	55.6	51.5	47.9
Bank certificates of deposit	—	—	—	—	—	—	—	—	0.5	1.0	1.5
Postal savings	9.4	9.3	9.3	9.4	9.9	9.1	8.2	7.5	7.0	6.6	6.7
Short-term Treasury bills	0.1	1.5	3.0	3.9	5.8	9.3	13.5	13.5	13.7	14.2	13.9
Bank acceptances	—	—	—	—	—	0.3	0.4	0.3	0.2	0.1	—
Specialized credit institutions' certificates of deposits	2.6	2.2	1.9	2.0	1.7	1.6	1.7	2.7	2.5	2.6	2.4
Treasury Credit Certificates	—	—	0.6	1.5	2.2	2.3	2.7	4.1	8.3	11.4	14.0
Other bonds	12.3	10.1	8.1	8.0	6.8	5.2	5.2	4.9	5.6	6.0	5.6
Atypical securities and investment funds	—	—	—	—	0.1	0.1	0.2	0.2	0.2	0.4	2.1
Foreign funds	0.4	0.7	0.4	0.4	0.6	0.8	0.5	0.6	0.6	0.9	1.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: C. CARANZA and C. COTTARELLI, *Financial Innovation in Italy, a Lopsided Process*, Bank of Italy, May 1986. The updating of the 1985 data by the authors is gratefully acknowledged.

because of the concentration on the Treasury of other public-sector agencies' requirements for finance. Foreign assets remain negligible, a tangible sign that the free flow of capital is still hampered.

Among the new assets, bank acceptances have experienced a brief parabola, which at its maximum carried them to 0.4 per cent of the total in 1981, only to become statistically insignificant in 1985. Atypical (*i.e.* non-standard) securities and investment funds are also barely visible up to 1983, when they begin to grow as a result of the establishment of Italian-law funds, and in 1985 these represented 2.1 per cent. The conclusion arrived at on the basis of the analysis of liabilities alone may be regarded as confirmed. That is, that monetary policy and public debt management have led to a change in the composition of portfolios, in which the new forms represent a prospect rather than an accomplished fact.

3.1 The most important example of financial innovation in the Italian experience is that of indexed bonds. The reasons for their tumultuous growth are to be sought in inflation and in the explosion of the public-sector borrowing requirement. Without the former, it would not have been possible to shorten the time horizon which dries up the medium-term fixed-rate markets, and, without the latter, there would not have been a phenomenon of such dimensions. The momentum for the use of indexed bonds came rather from the authorities, not only for Government securities, but also for those in the private sector, since the issue of bonds, like that of shares, is subject, above certain limits, to administrative authorization.

Once the stance of the monetary authorities changed in favour of markedly positive real interest rates, the problem arose of how to finance a growing public-sector borrowing requirement with securities which did not have to be renewed in the very year of issue. The option was then adopted of a type of financial indexing anchored to the yield of short-term treasury bills. For private-sector bonds, reference was also made to the interbank market rates or to the commercial loans market. This mechanism made it possible to satisfy savers' liquidity preference in a context of high and above all variable inflation, which did not allow them to express expectations regarding the rates which would have emerged in the medium to long term. On the other hand, it allowed the issuer to separate the interest risk, which he still had to bear, from the funding one. And the Treasury needed, in order not to hinder the orderly functioning of the short-term paper market, to reduce the speed at which its debt was turned over.

To conclude, indexing has the advantage of symmetry, so that, when inflation is falling, the debtor benefits automatically and with minimum delays from a fall in nominal rates. Even if, in the acute stages of inflation, there had been a willingness to pay a fixed rate of interest such as to induce savers to buy long-term paper, with the reduction in the speed of price increases the only possibility for the debtor of not dishonouring his bonds is to repay them ahead of time.

Financial or short-term rate indexing makes it possible to protect the yield of a medium- to long-term asset, which means that the capital loaned out, in real terms, is reimbursed partially through the installments of interest, and hence the repayment of principal is speeded up compared with that of the nominal capital laid down in the amortization plan. This front-loading effect has in part been obviated by the issue of Treasury Certificates in ECUs. To the extent that the inflation differential is sooner or later reflected in the exchange rates, the nominal capital in lire is revalued, and there is less pressure on the coupon to keep the capital unaffected by inflation. In addition, issues in ECUs have the task of offering savers a surrogate for assets in foreign exchange, which cannot be purchased on international markets due to present limitations, and of giving the issuer the possibility of affirming his confidence in the future of the European monetary unit.

Lastly, it is only real or price indexing which can completely correct the effect of the early redemption of the loan, but this type of indexing has not been much of a success, despite the favour enjoyed among academics and politicians. It was, and probably still is, opposed by one of the monetary authorities, which regards it as involving a surrender to inflation, incompatible with the aim of reducing the indexing of wages to prices, and dangerous for budget policy which would come to enjoy more room for manoeuvre by shifting forward, or at least financing automatically, a high proportion of an item of expenditure which at present is shown as current cost. This last consideration is also the one which has hampered the growth of zero-coupon securities and those with a deep discount. In the same vein, we would mention that, in the private sector, other innovations have appeared such as drop lock bonds or those *cum* warrant, but the only ones which have met with some favour are the convertible ones including those in shares of non-controlled companies (*i.e.*, indirect convertibles).

3.2 Of the innovations desired or favoured by the authorities, some, such as bank acceptances and repurchase agreements, have already had

their rise and fall. Others such as savers' shares and the analogous participation securities, are expanding vigorously and have good prospects of growth.

The story of bank acceptances is typical of the innovative developments created by fiscal regulation; the reduction of the stamp tax from 1 per cent to 1 per ten thousand favoured the issue of such securities. At the time when the ceiling on loans was in force which froze the market shares of the banks, acceptances made it possible to oil the flow of funds to some extent. In order to prevent the new instrument from circumventing the ceiling, the monetary authorities set quantitative limits on issues; the abolition of the ceiling removed the main reason for their existence. But the fiscal authorities dealt them a final blow when they made it clear that interest on acceptances was subject to tax.

Repurchase agreements are also due to the steps taken by the central bank to enable it to regulate bank reserves, as regards both purchases and sales of bonds, on a temporary basis and at rates in line with the trends prevailing or to be fostered in the market. This monetary control technique, introduced in 1979, was improved in 1981 by the insertion of a competitive mechanism. The imitation on the part of the banks was not welcomed by the central bank, since it amounted to a form of fund-collection. These funds were not shown as deposits, and were not subject to the compulsory reserve. When, at the end of 1982, the reserve requirement was extended to these operations, they disappeared from the banking scene.

Another innovation invoked especially by those bankers favouring a sharper distinction between checking accounts and time deposits is the bank certificate of deposit, the creation of which has been stimulated by a substantial improvement in the remuneration of the compulsory reserve due on these certificates, a remuneration which at the present time is not so very different from market rates. Nevertheless, their growth in 1983 was below expectations, and has recently induced the central bank to make the instrument somewhat more attractive by enlarging the number of maturities and facilitating the formation of a secondary market.

The financial market instruments which did not call for the creation of new intermediaries or quasi-intermediaries include savers' shares. These have been written down in the civil code since 1974, may be issued by all joint stock companies and are listed independently of ordinary shares, but cannot, together with the older privileged shares with limited voting rights, exceed 50 per cent of the equity capital. Their



main attraction for the issuing company, or to be more precise, for the group controlling the company, is the absence of voting rights, which is offset by a higher dividend; by the way, this privilege can be frustrated by an overvaluation of the price at which the savers' shares are issued. For the bearer, the advantage of the higher remuneration is enhanced by the fact that the coupon tax is a flat 15 per cent. This instrument has been growing rapidly in a favourable stock exchange climate thanks to good business profits (issues amounted to 514 billion lire in 1984, 816 billion in 1985, and 5,583 billion from January through September 1986). These developments have led the authorities in charge of issues on the primary market to show signs of concern, for they fear an excessive divergence between the quotations of ordinary shares and those of savers' securities, as well as the consolidation of the power of the controlling groups to a point far beyond what is in the interest of the company and the market. The reaction of those concerned has naturally been sharp and critical.

Some public-law credit institutions and also the savings banks have modified their bye-laws in such a way as to associate private capital with them for the first time. This capital has taken the form of savers' participation securities, which are not dissimilar in their technical and juridical connotations, as well as fiscal treatment from the corresponding savers' shares. In the three-year period 1984-86, issues amounted to 615 billion lire, which brought in over 1,350 billion lire of fresh money. Still more innovative are the ordinary participation securities which were introduced by credit institutions, and in particular by savings banks, which have the status of a public foundation. Their issue is at the present moment only matter for close attention and for debate. This is a singular case of a financial innovation desired by the authorities, but governed (and only on broad lines) by administrative fiat such as the bye-laws. Since there is no precise and abstract discipline, which in a written-law country such as Italy can only come from Parliament, we are dealing with a variety of atypical securities which are not generated by the inventiveness of the market. On the contrary, they are due to the aims of an easier capitalization and partial privatization pursued by the monetary authorities, who are both the authors and the victims of a policy of bailing out ailing banks — a policy which has caused the public sector of the banking system to grow at the expense of the private one.

3.3 Atypical securities, so called because they do not correspond to the characteristics of the archetypes laid down by law, are the brainchild

of the market in its attempts to exploit some loopholes in the civil, administrative and tax rules. Although fully in line with the tradition of financial innovation in other countries, where the market is expected to be alive to the slightest sign of weakening in the network of controls, and the authorities have to be attentive to the tightening of regulations or the legalization of new instruments, these securities are also atypical on the Italian scene in the sense that they have not been sponsored by the authorities!

In this case, too, inflation is at the root of the growth of new instruments; especially because the stock exchange was not able to offer any protection against monetary erosion and the Treasury securities were not yet offered at positive real yields, savers were seeking investments in real estate. The staggering increase in the prices of houses and land made it difficult to make investments directly. There thus grew up a demand for certificates linked to real estate. Such transactions relied, from the legal point of view, both on contracts of association by participation and on Swiss legislation on real estate investment funds. If we add to these factors the considerable tax immunity involved because of the uncertainty as regards the regime governing these securities, we can easily explain the favour accorded them by savers and the attention paid to them by the general public for some time.

Another line of atypical securities is strictly financial, since it originated in the credit constraint. Because of the rationing due to the ceiling, there was a drive to collect savings directly, short-circuiting the banks and the security market. This is the case with, for example, leasing concerns, which in Italy are usually financed by bank credit. Some of these firms had the idea of collecting funds directly from savers by issuing either certificates incorporating the contract of association by participation or investment warrants, which indeed were confined to the fiduciary management firms mentioned in the law governing insurance.

It would be boring, and useless after the almost complete disappearance of this phenomenology, to study securities which, at the height of their success, were available in fifty or so different forms. What is worth underlining, is that, in the second half of the 'seventies and in the early 'eighties, they represented a form of securitization which was not due to the banks, and preceded the developments on the international financial scene. It should be observed that securitization in the banking world was called into existence in order to afford various forms of credit

the chance of liquidation in the secondary market, the creation of which is its precondition. In fact, the Achilles' heel of atypical securities has been precisely the lack of a market on which they could be disposed of. Especially in the case of securities based on real estate, the possibility of liquidating the investment was linked to the demand of others to get into it. When the market "turned" and redemptions were the order of the day, the mechanism became clogged.

The crisis undergone by these new instruments arose when the conditions for their emergence no longer prevailed. Inflation, the fall in real estate values, the appearance of financial assets with a high real yield, and the disappearance of the quantitative constraints on the expansion of credit would have been sufficient to cut the phenomenon down to scale. And it was given a further blow — which may perhaps prove fatal — by two laws passed in 1983. One of these made the issue of atypical securities subject to approval by the Bank of Italy with a view to controlling flows of funds, and to the prior notification to CONSOB (the Government commission for the control of companies and stock exchanges) in order to ensure transparency. The other law, which proved much more effective than the first one in almost choking them off, imposed a withholding tax on all their earnings.

Savers' experiences with atypical securities have not been particularly happy. Some of them have turned into financial "bubbles" leading to insolvency and bankruptcy proceedings. In another case, undoubtedly the most important one — the venture is in the throes of a liquidity crisis which does not allow of redemptions, and hopes that its salvation will come through the Italianization of the fund. Still another, to conclude, which has enjoyed the greatest success, is seeking to leave this field and to transform itself into a regularly listed finance company.

The scanty civil law basis of these instruments, which leads some experts to doubt even their legality, is one factor calling for the legislative definition of intermediaries and quasi-intermediaries able to issue particular liabilities and/or to carry out specific activities. Other such factors are the wish of the fiscal authorities to have their task facilitated by the standardization of these instruments, the savers' demand for protection, which becomes more strident every time the market claims its victims, and even the self-interests of the official agencies which ought, from different points of view, to be concerned with supervision. Given the present international trends, the cumbersome nature of Italian legislative procedures, and the inevitable risks of cross-currents and overlapping, both between old and new intermedia-

ries and among the new ones, it may be doubted whether the Italian financial system is capable of keeping up with the times.

3.4 In 1983, together with the regulations governing atypical securities, Parliament finally approved the setting up of open end investment funds, which had been stranded for some twenty years on the debates regarding how they should be taxed. The Italian market, it is true, had long been familiar with the Luxembourg funds which were authorized by the Ministry of Foreign Trade to operate in Italy and were managed by important components of the Italian credit system. However, for that part not invested in Italian assets, their operations were subject to the non-interest bearing deposit. The growing strength of investment funds operating under Italian law coincided with an upswing in the stock exchange which to some extent it helped to intensify. In 1985 alone, net capital increased by about 18,000 billion lire, and in September 1986 it amounted to 62,500 billion, of which 19,600 billion roughly were invested in shares, 6,000 billion in bonds, and the rest in Treasury securities. A couple of years was enough to bridge the gap as regards investment funds between Italy and the other five major industrialized countries.

As is always the case when a financial phenomenon is regulated by law, the problem emerged of whether the existing fiduciary management concerns could legally survive. In addition, the rapidity with which the funds have grown has prevented the development of a code of conduct and a deontology ensuring the independence of those running the management companies from the group controlling them in, for example, the exercise of voting rights for the shares owned by the fund.

The greater part of the 59 investment funds operating today has a banking origin. Of the 38 companies managing them, 25 are tied to a bank or a credit institution at least in part, and are included in the ancillary activities which, without regard for technical or juridical precision, are referred to as quasi-banking. In this sector, it is customary to include leasing and factoring companies, both activities which seem to be moving towards definition and regulation by law. There is no denying the importance of leasing. At the end of 1985, the amount of operations outstanding was estimated at about 7,000 billion lire, and in the three years 1983-85 the annual rate of growth exceeded 20 per cent. The fact that four-fifths of the leasings were made by 78 companies owned or controlled by one or more credit institutions explains, together with the lifting of the quantitative controls on credit, why

reliance was mainly placed on bank credit for the supply of funds, and more particularly on credit from special institutions. The origin and the financial characteristics of leasing in Italy, moreover, is the main reason for the greater calm in this sector as compared, for example, with the German market, where industrial leasing seems to play a greater part. There is no doubt that, if it was desired to have a better definition of the rights, obligations and authority of the lessor and the lessee or even to permit the direct raising of funds, legislative regulation would sooner or later become inevitable.

Although in Italy factoring goes back to the 'sixties, it has recently expanded rapidly with the setting up of a number of companies coming mainly under credit institutions, but also under industrial or commercial groups. These companies are 40 in number. In 1985, their activity increased by 50 per cent, and, at the end of the year, loans outstanding were for a sum of 5,200 billion lire. In the absence of a specific discipline, a modified form of the contract for the sale of a credit claim was adopted. Current parliamentary steps to introduce legislative regulation will have to tackle the problem of the growing presence of industrial groups and to resolve any conflicts between credit activities on the one hand and industrial operations on the other, if the course to be pursued is that of continuing to keep them separate.

Other intermediaries seem to be lining up at the starting-post in the Houses of Parliament, from investment banks to pension funds, from real estate funds to closed unit trusts, from capital management to fiduciary management companies and to companies performing financial activities other than those specifically regulated. If too many intermediaries are fitted into the legislation, the Italian banking and financial system, which is not very diversified in its operational typologies, but can be controlled administratively with considerable flexibility, will become much more clearly structured, but also more rigid. Such an ample supply of regulation by law will very probably meet a strong demand for preferential tax treatment for the new intermediaries and/or instruments.

One last note. From the above remarks about innovation in the matter of instruments, it will be clear that the banking system, whose attitude is often (and has to be) conservative, has not been led to innovate even by the disintermediation stemming from the financing of the public-sector borrowing requirement on the market. For that system has not suffered any reduction in profits, since the placing of public debt securities has replaced the investment thereof in their contribution

to earnings. In addition, in my view, a factor not unconnected with this behaviour on the part of the banks is the close control exercised by the supervisory authorities. Much more attention has been devoted by credit institutions to innovation as regards intermediaries or activities which, over time, can give rise to new intermediaries. Thus, in addition to those already mentioned, we should recall underwriting activities, and above all the placing of securities, which some financial companies have developed admirably with the help of aggressive sales networks. This is true mainly for the biggest special credit institutions, which the crisis in the 'seventies steered more and more towards the financial market and which promoted several innovations in Italy in the bond sector.

#### 4. The deregulation-regulation process

A second component — and a formidable one — of financial policy in almost all industrialized countries has been the dismantling of regulations, which, for example in the field of interest rates in the USA, has taken the form of a veritable deregulation. In Italy, on the contrary, we are still at grips with the problem of liberalizing capital movements to other countries. Freedom of access for foreigners to the stock exchange, the creation of "market makers" and the abolition of fixed commissions are all still for a later day. Even continuous dealing by means of computers is only just beginning. In the Italian stock exchange, the broker still shouts his bids.

To the extent that some experience of structural deregulation took place, this could not but affect the most important and closely regulated component of financial intermediation — the credit system. In the case of the other components, on the contrary, the problem, which is now very much to the fore, is that of providing a minimum of regulation, or at least of supervision. The most striking example of the easing of certain structural constraints on the banking system is the lifting in 1986 of the suspension, laid down twenty years back, of the establishment of new banks. Since the European Economic Community has authorized Italy to avail herself, for a transitional period, of the principle of economic need, the formation of new banks is permissible, but subject to conditions which, however, to a large extent, restrict the authorities'

margin of discretion. With a view to adapting the banking structure to the different rates of growth in the various regions or market areas and reducing the degree of segmentation, new criteria have been adopted for the opening and transfer of bank branches and for the extension of the banks' geographical area of operations. Another, if modest, manifestation of deregulation is to be seen in the greater degree of autonomy accorded to the banks, which is graduated in line with their capital base, as regards the grant of larger and longer-term loans.

4.1 Financial intermediation, in fact, has been faced with the need to accommodate a minimum of regulation because of the lags in developing it in Italy. The scant importance of the stock exchange, which has led a perceptive economist to wonder whether it was worth while keeping that institution going, the absolute prevalence of banking and credit activity, the standardization of the instruments and the specialization of the roles had not, for several decades after the 'thirties, given rise to the problem of whether to adopt some form of regulation for financial activity.

It was only in 1974 that the setting up of CONSOB took place; the agency concentrated in its hands powers for long split up and ineffective — an operation envisaged as early as 1936 by the banking law of that year, but never implemented — and, in particular, it was given authority to supervise joint-stock companies, especially those listed, in respect of their balance sheets, the auditing of their accounts, and reciprocal participations. With the arrival of the 'eighties, the emergence of atypical intermediation and the creation of new intermediaries, a pressure was generated for the extension of CONSOB's field of operation to cover any kind of offer of securities to the public. In fact, in this perspective, regulations were promptly issued regarding offers by investment funds, services of fiduciary management, personalized capital management, and house-to-house sales of any security whatsoever.

The aim assigned by the law to CONSOB is to secure transparency, a need which, according to that Commission, has to be met through "adequate information, that is to say, which is not contradictory, nor misleadingly suggestive and not incorrect ... and lastly clear and as complete as possible". The instrument designed to achieve such transparency is the prospectus, which is to be made public after approval by the Commission. It need hardly be added that, as in the case of any official decision, the approval can only be accorded if the appeal in question does not run counter to "unbendable" laws or to public order.

This approach, which we have no difficulty in fully endorsing, might undergo radical changes if, in order to protect savings and the weaker parties, there was a reinforcement of the trend to use the prospectus in order to pass judgements on the dangerousness of the investment proposed. This would mean that, in the assessment of the risk, the supervisory authorities would replace the individual investor and the market as a whole. "Protective" attitudes are not foreign to Italy's credit and financial tradition. It is fair to ask, however, whether these attitudes correspond to the present needs, which militate in favour of an increased role for the markets and for their efficient functioning. One cannot be dogmatic on this point, and the line of demarcation between transparency and dangerousness clearly passes through a grey area in which opinions based on technical and administrative considerations may justifiably vary. If, however, we remember that the type of financial innovation originating in the market has been rarer in Italy than in other systems, we may well express concern regarding the trends at present emerging.

The hypothesis that we are on a slippery slope is confirmed by certain stances of the Commission itself, which is eager to extend its competence to the control of agents, especially intermediaries. Transparency applies to operations and not to operators. The affirmation was also made that "the control ... obviously cannot be confined merely to the prior check on the document represented by the prospectus, but should rather accompany and follow up the implementation of the proposal and the concrete developments of the fund-raising and fund-using activities ...". This means outlining "philosophy" which, in so far as it also incorporates the objective (referred to above) of limiting risks, might lead to a prudential supervision focusing on intermediaries, with the result that, sooner or later, the stability of the operators would be given priority over the efficiency of the market.

Such a potential development might be regarded as desirable in order to combat insider trading. The correct behaviour of the operators, together with the transparency of the transactions, ought to be the cardinal point of CONSOB's action. An easy way of ensuring the former desideratum might seem to be that of making all financial intermediaries subject to authorizations and controls. In our view, the financial system could be so regulated, without necessarily achieving the goal of curbing the vice of insider trading which is caused by the incorrect behaviour of individuals. The best way to cope with this abuse is one of the issues to which the profession should devote its attention

by developing a code of conduct and a deontology; also the administrative authorities and the legislators should keep a close watch on it. For its part, CONSOB has already expressed some interesting opinions on possible sanctions to be adopted in this connection.

## 5. Privatization

In the economic policy programmes of almost all the members of the Group of Seven, the sale of public-sector assets is one of the objectives of Government action. The reason for this is to be sought not only in the free enterprise/conservative ideology of many Governments. More generally speaking, the need has been felt to realize part of the public-sector capital in order to finance the budget deficit and reduce the public debt, as well as restoring to the realm of private property and management assets which no longer appear to meet a specific community need. In this perspective, too, Italian financial policy is not aligned with that of the main industrialized countries.

However, this does not mean that the problem has not fuelled public debate. Distinguished academicians and important politicians have come out unambiguously in favour of privatization, and, in the debate on the 1987 Finance Bill which precedes the Budget, they have also formulated specific proposals. Nor can it be said that the question is not within the Government's purview, since the Prime Minister's Office has appointed a commission to study it. Something, however, has been achieved, and, since it is a matter of public ownership, individual ministries and individual ministers had to be involved.

Two examples spring to mind. There are the public-sector banks, including savings banks, and there are the State participations. In both cases, the factors making for the adoption of a policy of privatization was the State's financial crisis and the resulting impossibility for the Treasury of meeting all the demands for funds, the return on which would have been little or nothing, but which would have increased still further the Treasury indebtedness at high rates in real terms. For the savings banks, which have never drawn on the public purse in order to boost their own funds, there was also the desire to open up to the market by conferring a hybrid status on their capital, which remains partly that of a foundation and partly becomes that of a kind of financial

company. For the public-sector banks in the narrow sense of the term, it was their needs for capitalization which forced them either to envisage greater private participation or to resort for the first time to such a course of action. For the State participations, it was the pressure to reduce allocations to their endowment funds which drove IRI, and to a lesser extent ENI, to sell part of their share holdings on the market. It was in this way that shares in banks, telephone companies, sub-holding companies, and airlines found their way back into private portfolios, though in all cases the majority shareholder remained the public sector.

The IRI formula has been rediscovered, a formula which won numerous successes and acknowledgments in the 'fifties and 'sixties, and which went through a crisis in the following decade, together with all heavy industry. Indeed, since IRI is present in the capital-intensive and high productive-capacity sectors, it ended up by faring worse than the other conglomerates. In 1983-86, sales of participations brought in about 4,200 billion lire to the IRI group, while sales of real estate and land fetched over 900 billion. These results were achieved in part because industrial profitability was restored and, obviously, because the stock exchange boomed. For ENI, on the contrary, the phenomenon was on a much more modest scale (involving about 300 billion lire in 1984-86), but it is none the less significant since the group does not traditionally favour participation by private investors, as the high degree of integration between the different operational companies in the energy sector makes them less suited to the presence of a heterogeneous set of shareholders.

While the sales on the stock exchange decided on by the managements of the two groups took place without any special clamour, the case is different as regards the disposal, attempted but not realized, of the whole food sector of IRI. The lack of tried and tested procedures for divestiture of entire sectors, the unsuspected but tardy demands on the part of various competing groups and the resulting political polemics explain why the sole result has been a series of judicial wrangles, and, at least for a certain period, uncertainty regarding the future of the companies for sale. Fortunately, the second attempt to sell a whole sector — the car-manufacturing one — was successful, and may thus cancel the memory of the earlier abortive move, specially so if the new venture gives satisfactory results.

If we look at the two paths followed on the road to privatization, we will see that the Italian tradition of associating private with public-sector capital has stood the test. It remains to be seen whether, to

achieve a better functioning of the market, it may not be preferable to effect sharper vertical separation, which means that firms earmarked for privatization should be sold *in toto*, and that the few firms to be retained in public hands should have specific objective functions, or at least functions differing from those of a private firm of the same type. The French policy as regards privatization seems to bear the stamp of the second formula.

## 6. Conclusions

Two final remarks. The first refers to the vitality of the stock exchange, the capitalization of which went up from 35,000 billion lire to over 200,000 billion from the end of 1983 to the end of 1986. It is not just this result, due in turn to the positive conditions and profit expectations in the business sector, which makes such a favourable impression on anyone observing and comparing the main world stock exchanges. The structure of demand, too, has changed as the result of the arrival of investment funds, the interest of foreign investors, and the desire of numerous households to bring their portfolios back into equilibrium by cutting down the excessive public-sector securities with which they are swollen — a process in which they have been aided by the banks and by enterprising financial companies with a host of seasoned vendors. The proof is that the rising cycle in quotations was not halted by the imposition of the compulsory deposit.

As to supply, stimulated by the trend towards real rates of interest which made bank debts less attractive, we should emphasize not only the large volume of resources which the stock exchange succeeded in supplying to firms (about 5,000 billion lire in 1985 and 9,400 billion in the first nine months of 1986), but also a tendency to lengthen the list (40 new securities were added from the end of 1984), although the relative scarcity of medium-sized firms may keep the number of recruits, at least in the official market, at rather modest levels. What the stock exchange needs, as has already been suggested, is an improvement in operational methods, easier access to it by operators, and a reduction in the time taken to effect the actual handover of securities. All these points lie in the technical and juridical sphere, but do not pertain to the economic substratum which at the present time seems to call for a more

ample financial market befitting a highly industrialized country. The bears will come back, but, if this analysis is correct, we may reasonably expect them not to descend into the lowest valleys.

A second reflection, of necessity a very brief one, is that we are moving towards the globalization of markets, especially financial ones, thanks to the securitization of bank credit claims. Complete participation by Italy in this international trend cannot but be linked to the completion of foreign exchange liberalization, which will still take some time, but which cannot indefinitely be delayed, because of the pledges made to the European Economic Community. It is to be hoped that this breathing space will be used by the authorities and operators alike in order to define a set of rules, standards of behaviour and modes of operations which will make Italian markets — the financial one in general, and the stock exchange in particular — not too dissimilar from those of the main European countries. Such a development would be the proof of Italy's rediscovered faith in the ability of the market to effect a sound allocation of resources and of the Italians' vocation to live as Europeans in an integrated world.

Roma

MARIO SARCINELLI