

Concluding Remarks for 1960

Gentlemen,

The concluding part of the Annual Report is the quintessence and synthesis of the detailed and carefully documented analysis presented in the separate chapters, thanks to the team work of our colleagues in the offices of the central administration and the managers of the Bank's branches. It is to them that belongs the merit, if merit there be, for the Report and it is they who have spun the red thread which runs through my concluding remarks. I express my warmest appreciation to them all.

World Economic Conditions and Monetary Policy

The economic results achieved by the industrial countries in 1960 are amongst the best since the close of the war. Although the resumption of the expansive movement was well under way in 1959, last year production went on expanding at high rates everywhere except in the United States, to reach new peaks far above those of the year before.

The growth of productive activity in the countries of Europe was, at different times, sustained in turn by all components of demand: at first mainly by export and stockbuilding demand, then by domestic consumption and investment demand, and most recently especially by this last-mentioned component of internal demand, that is, new investment by firms. In this sequence lies the origin of the conspicuously high rates of annual increase of all the elements of total demand, and also of the relatively more marked expansion of trade among the industrial countries in comparison with other trade flows.

As regards the outlook for the current year, we should wish merely to underline that all the most authoritative forecasts agree in expecting the favourable trend to continue in the months to come, although the results may not equal those achieved in 1960.

The contrast between the recession in the United States and the booming economies of Europe bumping along the full-employment ceiling necessarily led to policy differences and caused certain strains, which were manifest above all in differential money rates and in international payments disequilibrium.

These are problems which concern more particularly the behaviour of money and exchange markets and the development of international payments, all of which concern us closely and engage our responsibility. It is to these problems, therefore, that we shall devote our main attention in the first part of our remarks.

The asynchronous timing of cyclical phases in the United States and in Europe as well as among different groups of countries within Europe enabled extreme fluctuations in both senses to be flattened through the vehicle of international trade, which made room for a redistribution of capacity utilization transcending national frontiers. At the same time, currency convertibility added greatly to the mobility of money flows among industrial countries.

If, then, the past year was one in which the volume of the international exchange of goods and services expanded sharply, especially as between the United States and Europe, it was also a year of huge international movements of short-term funds in directions which did not always suit the economy of the countries concerned. The growing time lags in cyclical developments vastly magnified the flow of funds already called forth by a, sometimes considerable, margin of money rates and this flow was further swelled by sudden movements of hot money in the expectation of parity changes.

The resulting large and, in some cases, persistent accumulation of surpluses by some countries and deficits by others caused unusually heavy balance-of-payments disequilibria as well as large scale transfers of international liquidity reserves, so that the monetary authorities had to intervene with energetic measures. These events, punctuated by a number of symptomatic episodes in the gold and exchange markets, have revived the discussion of international liquidity problems and have forced them upon the active consideration of scholars and politicians alike.

The conflict between internal and external needs not only placed a difficult choice before the monetary authorities, but also did much to aggravate still further the operational conditions of various markets already disturbed by the transfer and repatriation of funds. While in the United States the outflow of capital added yet another factor of

slackness just when production levelled off and the economy entered a phase of recession, the simultaneous inflow of funds into Europe defeated, at least to some extent, the authorities' efforts to brake the excesses of the boom through the regulation of market liquidity and of credit.

The difficulties of monetary action in the economic and financial setting of 1960 were outstandingly evident in Germany, where eventually a reappraisal of policy culminated in the revaluation of the Mark last March.

In other countries monetary measures were perhaps less widespread and frequent, in part because the expansionary forces appeared concentrated and circumscribed within the sphere of private consumption, and in part because large budget surpluses helped to keep demand down to more easily manageable levels. When central banks intervened, mainly by altering Bank Rate, their decisions were often inspired by external motives, such as, at first, the desire to strengthen foreign exchange reserves and later that to check the flow of hot money.

Considerations of this kind ultimately prevailed over those of an internal character. This was the case, for example, when, at the end of 1960 and in the first few months of 1961, many countries felt able to relax the credit restrictions they had imposed earlier. But this tendency was also due to considerations as to the possibility and indeed the advisability of influencing the level of demand for goods and services by predominantly monetary means.

From this point of view, the greater stress placed both in academic discussion and in the programming of public activities on general economic measures and fiscal instruments testifies to a growing awareness of the need to surround monetary policy with other appropriate measures if it is to achieve the desired effects.

International Payments and Liquidity Problems

For ten years now world trade has been expanding by leaps and bounds and the relative balance-of-payments situation of the European continent and the United States has capsized in Europe's favour. These events have raised the problem of the adequacy of

international monetary reserves and, in unexpected guise, also that of their distribution. Last year, the intensification of international movements of short-term capital added a new dimension to these problems.

The circumstance that the United States and Western Europe were cyclically out of step in 1960 strongly influenced the leading countries' balances of payments, not only on current but also on capital account. In Europe, the expansion of domestic demand, coupled with a slowing down of the rate of increase of foreign demand, cut into current surpluses. The extent of the diminution varied from country to country; in the United Kingdom, the slight surplus of 1959 turned into a heavy deficit in 1960. In the United States, on the other hand, the progressive slackening of domestic demand made room for a considerable improvement in the current balance and more especially in the merchandise balance, which reaped the full benefits of rapidly growing foreign demand.

In the light of the present situation of international payments and of the geographical distribution of official gold and foreign exchange reserves, it must be stressed that short-term capital movements did not, in general, exercise an equilibrating influence. They were able to grow thanks to progress in the liberalization of capital transactions, especially since the restoration of convertibility, and thanks also to an improved balance-of-payments structure.

However, there is not, as yet, anything like unanimous agreement as to the advisability of complete liberalization of capital movements. Above all, it is doubtful whether such liberalization can be achieved without prior co-operation arrangements among the various countries' monetary authorities.

Although great care was taken not to re-create conditions apt to disturb the system of international payments, the progress of liberalization has, at any rate, gone far beyond anything envisaged in the early post-war years, especially with regard to capital movements. Last year the concentration of increases of gold and dollar reserves in a few countries, whose current balance of payments hardly improved at all, clearly shows the importance suddenly assumed by capital movements, and especially short-term ones.

Enormous transfers of funds from one centre to another preceded and followed the rise of the London gold price and the revaluation of the Mark and the guilder. These displacements put the spotlight on the perils to which all currencies, and more particularly

the key currencies which discharge their international reserve function by piling up short-term debts, are exposed in a world from which administrative controls have gone, one after the other. This situation is full of dangers for the orderly functioning of international payments and accordingly the monetary authorities of some countries have intervened in a number of ways and sometimes by emergency measures.

Apart from their action for immediate purposes, the authorities turned their attention to the two more general and interdependent questions of the adequacy of world external liquidity reserves and of the strength of the present system of international settlements, based on the contribution to reserve formation of the currencies habitually used for this purpose, namely, the dollar and the pound sterling.

The good-creditor policy pursued by the United States during the whole period up to 1957, when their current balance remained especially favourable, ended up with a redistribution of reserves which eliminated the second world war's heritage of distortions and reflects in a much better way the present relative weight of the industrial countries in world trade. The countries whose reserves are patently inadequate are mostly primary-producing countries, and they owe the shortage to their development programmes and to adverse terms of trade. However, even in their case the problem is due not so much to the malfunctioning of the international payments system, properly speaking, as to the failure of foreign long-term capital supply to match the requirements of intensive development programmes. This problem was approached in the right way when the industrial countries last year took measures to co-ordinate and amplify their financial and other aid to developing countries.

So far, then, there is nothing to suggest that the international liquidity situation calls for drastic reforms, at least in the short period. However, the problem of ensuring a growth in international liquidity reserves sufficient to give free rein to the expansion of world trade might well arise in a longer-range perspective. If the working of the international settlements system has lately given cause for concern and has put some currencies under strain, this was, we repeat, in large part due to the extraordinary volume of short-term capital movements.

To cope with the upheaval in the wake of the Mark and guilder revaluation, central banks quickly agreed on effective concerted action. This is proof that the present mechanism of payments is

capable of reacting smartly even to large-scale speculative attacks. Moreover, the measures adopted in the heat of the moment have furnished valuable indications on the possible means of strengthening the system's resilience in the future without falling into hard-and-fast automatic patterns which are harmful as a general principle and closed to the benefits of experience.

These indications suggest that if the central banks of the leading countries were to co-operate more closely and at more differentiated levels than they have done in the past, they could constitute a strong first line of defence. The aim should be to make wider, though not necessarily less selective, use of various technical means of intervention designed to achieve, in accordance with the needs of each separate case, either a saving of reserves or the activation of excess reserves.

Concerted action of this kind would be an opportune step towards greater solidarity among the institutions directly concerned. It would, of course, presuppose that the monetary institutions of some major countries, which in the past followed the practice of keeping all or very nearly all their reserves in gold, should be willing to keep also other countries' currencies as reserve. That would enable them to pursue more active policies on the exchange markets, where suitable and timely intervention might counteract undesired capital movements before they ever reach unduly large proportions.

Arrangements of this kind might, then, provide a first line of defence to support currencies which may in the future come under pressure as a result of adverse short-term financial operations. However, by its very nature, this type of assistance would be indicated only in the case of operations of not too broad a scope in respect to both amount and duration. It follows that central bank co-operation needs to be properly integrated into the existing structure of international financial machinery and institutions.

The existing regional organizations in Europe could furnish a suitable institutional framework for a satisfactory development of direct first-aid arrangements among central banks. In its turn, the International Monetary Fund, whose operational principles are now being re-examined with a view to adapting them to the new situation created by the progressive dismantlement of foreign exchange controls, could become a second line of defence. This would be much stronger, given that the Fund's operations are not so limited to the very short period and thus are formally regulated for their entire duration.

Within a coherent scheme designed to make full use of the existing international monetary system's potential capacities both under its technical and its institutional aspects, the resources of the Fund could be used for financial assistance which proved to be necessary beyond the limits of amount and time admissible for direct action on the part of central banks. To enable the Fund to discharge its functions effectively, member countries should examine not only how more active use can be made of the Fund's existing resources, but also how they can be strengthened sufficiently to meet any foreseeable needs of the major countries, even beyond the Fund's present limits of intervention.

To sum up, it may not come amiss to stress that, while the central banks' determination to work together more actively may in itself constitute a sound defence against possible speculative runs on one currency or another, any new technical formula devised to this end would really do no more than reinforce a mechanism which already exists, with the object of assuring countries that lose reserves an adequate margin of time for the adoption of countermeasures to redress its foreign balance.

In some cases, the new techniques would involve no more than institutional changes; in other, more frequent, cases monetary, financial and general economic policies may have to be revised in the light of particular cyclical developments and in accordance with the commitments undertaken by countries when they made their currencies convertible.

It seems obvious enough that whatever measures may be adopted to render the international payments system more resilient and flexible, these cannot solve the problems due to basic disequilibria in the balances of payments. No device of international monetary technique can cure evils deeply rooted in the slow rate of economic development in some countries with respect to others, or in the scant energy deployed in safeguarding internal monetary stability.

The effectiveness of monetary techniques and instruments ultimately depends on political resolve and on the concerned countries' success in their efforts to eliminate the internal causes of structural imbalance in external payments. There is indeed evidence that the principal countries are acutely aware of this – witness the recent and highly promising approach to common problems within the consultative agencies of the nascent Organization for European Co-operation and Development.

Italy's Balance of Payments

In Italy, too, 1960 was a year of strong economic expansion, but, unlike other countries, she escaped the strains and stresses of unbalanced total demand and supply. This she owed to the existing margins of unutilized capacity and labour and to larger imports, unrestrained by balance-of-payments difficulties or scarcity of reserves.

The expansion of global demand called forth, on the one hand, a strong increase in output and employment, and, on the other, a growth of imports well in excess of import increments. As a result, the export surplus on goods and services account, which had amounted to nearly 500 million dollars in 1959, dwindled almost to nothing and the total of resources absorbed by domestic investment and consumption grew more than national income.

One of the principal causes of our greater purchases abroad was the strong rise in fixed investment, especially in the private sector. Consequently, the biggest import increments occurred in manufactures, and more particularly in capital goods. While the general volume of imports increased by 40 per cent, the volume of capital goods imports rose by 63 per cent.

A strong increase in food imports – 44 per cent in quantitative terms – was due to internal imbalance between demand and supply. While demand rose strongly under the impact of growing incomes, supply was limited in part by poor harvests of a few major crops and in part by the difficulties of adapting the volume and composition of agricultural output to growing consumption and changing consumer tastes. Another import-raising factor during the first half of last year was the rebuilding of stocks of industrial raw materials and semi-manufactures.

The current process of industrialization and specialization naturally has its effects on the structure of our exports. The tendency for the share of manufactures to increase is reinforced by the expansion of credits for capital goods exports to developing countries.

In practice, this means a relatively larger increase in the export of goods which incorporate a higher proportion of value added, with a preponderant contribution by the factor labour. The export figures for engineering products and textiles classified by their degree of processing fully confirm this tendency.

The combination of the two circumstances that structural factors play a considerable part in our imports and that a growing proportion of our manufacturing output is sold abroad imposes upon us the imperative task of keeping our domestic price level in line with world prices and making production flexible enough to adapt itself to the shifting requirements of an open economy.

In effect, if we have been able to sell more abroad and in general to produce more, we owe it to our having rendered our prices internationally more competitive by preventing production costs from rising faster than productivity.

Last year's Annual Report warned that, after two years of large surpluses, the balance of payments on current account was tending to return to equilibrium. In the event, the current surplus dropped in 1960 from 681 to 255 million dollars. This is almost the exact counterpart of the inflow of emigrants' remittances; imports and exports of goods and services were practically in balance and would indeed have shown a deficit if the terms of trade had not improved in the meantime. This year, according to exchange data, the first quarter closed with a deficit of 88 million dollars on current account, compared with equilibrium in the corresponding period of last year.

The year 1960 was also marked by very large capital exports, in the form both of Italian investments abroad and exports against deferred payment. In July 1959, Italian companies were authorized to establish foreign branches at their discretion and to subscribe capital to related firms abroad without prior specific permit. These measures showed their full effect last year. Total capital exports under these headings, involving foreign exchange transfers and unrequited exports of capital goods to foreign associates, reached the impressive figure of 170 million dollars. In turn, exports against deferred payment amounted to something like 200 million dollars. The two curves of exports and export receipts have shown in 1960 a progressive tendency to diverge from each other.

However, the most salient feature of the year in the field of capital exports was the extraordinarily large increase of 410 million dollars in the Italian banking system's foreign assets following a set of measures which first entitled banks to build up their own foreign currency holdings and then enjoined them to eliminate their net debit positions in foreign exchange.

This considerable outflow of Italian capital was only partly offset by an increase in foreign investment in Italy, large though it was. On

balance, capital movements reduced our official gold and foreign exchange reserves by 237 million dollars in 1960, whereas they had added 182 million dollars to our reserves in 1959.

The present tendency for the balance on goods and services account to fall again into deficit makes it plain that last year's capital exports were of a temporary nature and that Italy cannot as yet be numbered among structural capital exporters.

Consequently, if we consider the two most pressing international economic problems now engaging the attention of governments, namely, aid to developing countries and international liquidity, Italy's contribution will have to be more particularly concerned with the latter, which is more appropriate to our present situation.

While Italy has not failed, and will not fail, to help also in the solution of the former problem, her contributions will have to respect limits and take forms compatible with the requirements of her own economic development. These are the principles behind our recent measures concerned with insurance and credits for projects executed abroad by Italian firms, and also the proposed bill on export credits, which has already been approved by the Senate and provides for new forms of financing to importers in developing countries. These new forms are more suitable for the needs of these countries and at the same time more in line with the principles of sound monetary policy, in so far as it will become possible to raise the required funds on the capital market and so to avoid the danger that the central bank may have to foot the bill for export credits, as happened more than once recently.

Given our own need to go on expanding employment at home, our future contributions to developing countries will, in any event, call for a comprehensive foreign aid programme. We shall have to decide not only on the overall volume of domestic resources which can be deflected to this purpose, but also to specify the sectors in which output can be further increased to meet the particular needs of these countries.

In the field of international liquidity, Italy took the helpful step last year of eliminating the debit balance of the foreign exchange position of the banks vis-à-vis foreign countries via an increase in foreign currency lending abroad.

This was accomplished almost entirely by means of purchases of spot dollars from the Italian Exchange Office against lire and subject to a re-purchase agreement; in this way it was the Exchange Office

and not the banks which assumed the dollar exchange risk. These various operations in turn led to a reduction of official dollar reserves financed by the Exchange Office with domestic currency issued by the Bank of Italy. At the same time, the Italian banks' dollar holdings increased and the burden of financing total foreign exchange reserves shifted in some measure from the Exchange Office to the banking system.

While these measures were dictated by cyclical developments, they have had the consequence that the Italian banking system is now taking a larger part in the two-way operations of borrowing and lending foreign currencies abroad, and is doing less of its former business of borrowing foreign exchange abroad for domestic lending.

The obligation on the banks to eliminate their foreign exchange debit balances is part of a policy designed to facilitate internal liquidity control by protecting the domestic market from the potentially disturbing effects of certain short-term capital movements.

These are some of the less well-trodden paths along which monetary policy can proceed. The regulation of bank operations with foreign countries offers other opportunities of intervention to this purpose, which have gained in importance with the recent expansion of this type of business.

A point to stress is that the banking system has increased its assets in foreign currencies abroad well beyond the measure which would have been necessary to comply with the requirement to eliminate its net debit position in foreign exchange vis-à-vis foreign countries. In this manner the banking system has built up a liquidity reserve in convertible currencies. On March 31 of this year, this reserve, calculated as the difference between the bank's lending and borrowing abroad, amounted to 57 billion lire.

The net foreign exchange credit position of the Bank of Italy and the Italian Exchange Office increased by 572 billion lire in 1959 and by 65 in 1960. This change represents the burden of financing which fell upon the central bank. Given that the banks increased their net foreign debit position by 54 billion lire in 1959 and reduced it by 208 in 1960, liquidity creation due to the foreign sector diminished from 518 billion lire in 1959 to 273 billion in 1960.

Production and the Sources of Finance

The general conditions of economic activity in 1960 were, at least in part, the result of developments during the preceding two years, when high liquidity formation and the reduction of interest rates prepared the ground for the growth which took place during the second half of 1959. The expansion of foreign demand and later the expansion of productive investment gave new impulse to the upswing.

Foreign trade acted both as an expansionary and as an equilibrating factor.

After growing still further in the first few months of last year, foreign demand settled down at the top, though not without faltering somewhat around the middle of the year. In the most recent months it showed promising signs of going ahead once more. In its turn, investment in plant is picking up again after coming to a halt on a high plateau last summer. This tendency was recently reinforced by renewed activity in building, both public and private. The reconstitution and adjustment of stocks to higher activity proceeded at a brisk pace during the first half of last year. Stocks continued to increase later on also, especially for work in progress, in connection with growing output.

The persistence of the boom enabled employment to expand very considerably and, with wage rates rising at the same time, there has been a conspicuous increase in disposable income for consumption.

In response to these various impulses, industrial output rose at altogether unprecedented rates. The annual index of industrial production was actually 13.7 per cent higher than the year before and placed our country ahead of all other main industrial nations of Western Europe, so far as growth of output is concerned. We are still in the lead, and although the rate of expansion slowed down during the second half of last year, the index for the first quarter of 1961 is nearly 10 per cent higher than that for the corresponding period of 1960.

A signal contribution to the overall advance of industrial production was made by the producer goods sector and more particularly by capital goods, which surged ahead at the average annual rate of 19.4 per cent.

Contrary to what happened the year before, public building provided no further stimulus to demand; indeed, had it done so, it might have over-heated the economic activity. It is in this light that we have to assess the pause in public works construction last year and also its recent revival.

With productive activity expanding all round, the economy had a greater need of working capital, not least for larger stock in trade and work in progress. In response to this need, short-term credit to the private sector rose by the conspicuous amount of 1,186 billion lire, compared with 678 billion in 1959 and 203 billion in 1958.

The banks' investment portfolios rose by 264 billion, which is only about one-third of the preceding year's increment of 794 billion. The exceptional increase in 1959 was largely due to Treasury bill purchases in the considerable amount of 501 billion; with lower liquidity in 1960, the banks bought only 47 billion's worth of Treasury bills.

In both years, banks invested heavily in private securities and more particularly in bonds of special credit institutes, of which an additional 232 billion were taken in last year, against 217 in 1959.

These loans and investments were largely covered by net deposits, though the banks also had to draw on the liquidity reserves they had built up in preceding years; to a much smaller extent, they had to resort to borrowing from the Bank of Italy.

New deposits in 1960 amounted to 1,368 billion lire (as against 1,271 the year before), but, since 307 million had to be paid over for compulsory reserve, only 1,061 billion have remained available. In addition, the banks were supplied with 69 billion from sources other than ordinary deposits, 37 billion through borrowing from the Bank of Italy and 322 billion drawn from liquidity reserves; this latter figure is the resultant of a 359 billion reduction in free Treasury bill holdings and small offsetting increases in other liquid assets.

Ample liquidity on the capital market and the lower claims made upon it by the Treasury enabled the private sector to raise medium- and long-term funds in the total amount of 1,638 billion, partly through loans and mortgages and partly through share and bond issues. In 1959 the corresponding amount was 1,064 billion.

This is a very considerable increase, which alone just exceeds the increase in gross fixed investment during the same period. Simultaneously, companies accumulated larger internal funds from depreciation and other sources of self-financing; all these remained at

the companies' disposal and so served to improve their liquidity position, or at least to contain the deterioration which would otherwise have resulted from the financial requirements of increased stockbuilding and higher activity.

However, not all firms were able to take advantage of medium- and long-term funds to strengthen their liquidity position. On the whole, the beneficiaries were companies which could appeal directly to the market through bond and share issues. These companies raised far more medium- and long-term funds than they needed for the year's fixed investment, and were therefore able to use the excess to consolidate their short-term debts and sometimes to reduce their bank debts, and for the rest to deposit funds with the banking system pending their use in future investment programmes.

If we have dwelt at some length on all these aspects, it was to show that, however much the banks' short-term assets expanded, they still do not reflect the full measure of the productive system's short-term increased credit demand. Another important point is that the overall improvement in business liquidity was the result of two different developments: companies which were in a position to shift to short-term uses the funds they had raised on the capital market gained while others suffered appreciable liquidity losses.

In all, the private sector in 1960 raised a total of 880 billion lire through loans and mortgages and another 758 billion through share and bond issues. This latter figure was approximately double the 1959 one, while loans and mortgages had amounted to 691 billion in 1959 and to 580 in 1958. Total security issues, excluding government bonds but including bonds floated by special credit institutes which passed the proceeds on to firms in the shape of loans and mortgages, rose from 601 billion lire in 1959 to 1,160 billion in 1960; 664 billion of which was raised through bond issues and 496 through share issues.

The capital market's friendly disposition enabled the cost of borrowing to continue and indeed accelerate the steady descent it had begun in 1958.

Demand for securities kept growing all the time, boosted not only by larger saving but also, and even more so, by the Italian investors' growing interest in this form of investment and by the strong growth of foreign investment.

Bond and share issues together amounted to 71 per cent of new liquid assets in 1960, whereas the corresponding percentage had been 48 in the two-year period 1958-59 and 45 in 1956-57.

As regards the increase in foreign demand, the figures speak for themselves: net foreign investment, mainly in equities, was 142 billion lire in 1959 and 278 billion in 1960.

Large as it was, the increase in new share issues was not sufficient to match demand and the resulting strain was reflected in stock exchange prices.

The period of steadily rising share prices coincided with the strongest expansion the Italian economy has known since the stabilization of the lira in 1947. It is not by accident that share prices declined most steeply precisely at the end of last summer and in the autumn, when there was some uncertainty about the chances of continued rapid development; similarly, the subsequent recovery of share prices towards the end of the year and the more recent rising trend followed close on the heels of a distinct improvement in the economic outlook both for Italy and the world at large.

Nor were the mentioned basic factors at work in the stock market the only ones to have influenced the equity markets. Other financial and also institutional factors combined with them to cause unusually wide fluctuations in equity prices.

The liquidities left, at the time, at the disposal of the market and the banking system to bolster the production drive, were bound to find their way, directly or indirectly, also to the stock exchange and into stock market operations. This is no unsound development as such, and so long as stock exchange business expands in step with the economy and avoids excesses it provides the basis of a healthy capital market.

But the adjustment process in equity prices went on at a time when the basic bull factors were especially active, while the rapid widening of the market raised new institutional problems which could not be solved so quickly. In these circumstances the market occasionally moved ahead much in excess of its normal rate of development, in spite of the fact that right through the year, including the period from January to September, the market's and the banking system's liquidity diminished steadily.

What happened was that despite large increases in output some companies still found themselves in a liquid position, so that the increase in short-term credits to the private sector, while in itself considerable, was not enough to absorb the full credit potential and left some of it free for other uses.

When bank liquidity eventually fell further, not least because of increased credit demand by firms, this happened to coincide with the period of uncertainty to which allusion was made above, as to whether the basic sustaining causes of the equity firmness were likely to continue. The ensuing reversal of trend, supported also by speculative forces encouraged by the narrowness of the market and the relatively small number of so-called institutional investors, caused the September-October downturn.

Once a series of sharp fluctuations had eliminated the peak of last August and September, the market settled down and later again developed a fairly firm tone.

For the rest, prices on leading stock markets elsewhere in Europe also moved around their highest level since the war. The decisive advance of equity prices throughout the first nine months of the year gave way to a sharp retreat early in the autumn, the fall being most painful where the preceding rise had been largest and most prolonged; later, share prices recovered some of their losses and settled down in a calmer market. The corrective movement, incidentally, also coincided with a spate of new issues in connection with large-scale capital increases, and this was without doubt a contributory cause in the setback and new equilibrium of the stock markets.

Turning now to the medium- and long-term loans of the special credit institutes, we note that they increased by 566 billion lire in 1960, as against 375 in 1959.

The institutes which expanded their credit most are those engaged in financing industry, public works and building. By contrast, land-improvement credits by agricultural credit institutes expanded no more than they had done the year before.

The industrial credit institutes owed the broadening of their operational base not only to the liquid position of the market, which enable them to raise funds at a lower cost; a major factor was this credit sector's own structural evolution and technical improvement, as well as its closer collaboration with commercial and savings banks. These latter help both in fund-raising and in lending, and moreover spread the loans more widely and so work to the special benefit of small-scale and regional enterprise.

In 1960 it was not only the major institutes that expanded their activity, but in considerable measure also the newer and smaller institutes. The bank sections concerned with public works and public

utility installations had 111 billion's worth of loans outstanding at the end of the year, representing an increase of 53 billion; not the least merit for this belongs to five new sections which only started operating during the year.

This is a useful experience which has its lessons also for purposes of credit assistance to agriculture. If the volume of land improvement credits is to expand as envisaged in the overall investment programme of the Green Plan, it will be necessary not only to adjust interest rates to the peculiar needs of agriculture but above all also raise much more funds through bond issues.

As regards the geographical pattern of the special credit institutes' lending operations, the southern regions and the islands have considerably improved their position, also in relative terms. Nevertheless industrial development in the south will require much more further help from all credit institutes.

The Money Market and Liquidity Control

The trend towards a widening of the money and capital markets became more pronounced in the course of 1960, when total new assets amounted to 3,240 billion lire. This was more than 600 billion in excess of asset formation in 1959. The flow in 1960 was composed as to one-third of securities and as to two-thirds of other credits.

With particular reference to the money market, it is common knowledge that the economy's additional demand for liquid funds in connection with a growing volume of money transactions can be met from three distinct sources: one external source, namely balance-of-payments surpluses leading to the net purchase of foreign exchange, and two internal sources, namely the public and the private sector's short-term borrowing.

In the five years from 1956 to 1960 the development of primary liquidities, that is, note and coin circulation plus current accounts, proceeded on exactly parallel lines with the development of short-term credits. Secondary liquidities (including bank deposits other than current accounts, short-term advances to the Treasury and Treasury bills) expanded somewhat faster, so that their share in total liquid assets has risen from 38.8 to 45.1 per cent. With primary

liquidities expanding at higher rates than national income, the velocity of circulation of money supply has been falling, as it typically does in periods of growing confidence in the stability of the value of money.

Together, primary and secondary liquidities have, then, expanded more than short-term credits; the excess was transferred from the money to the capital market. In our credit system, this transfer mainly takes the form of bank funds being made available, in due proportion with other assets, to medium- and long-term credit institutes and sections.

If we look at the relative contribution of the various sources of liquidity to total liquid asset formation during the last five years, it will be seen that the public sector has been playing a progressively smaller and the foreign and private sectors a larger part. In 1960 the private sector was especially predominant.

The annual rate of increase of the Treasury's short-term borrowing diminished throughout the period 1956-1959, except for 1958, a year of ample liquidity when no government loans were floated on the capital market and the Treasury made heavy claims on the commercial banking system. In 1959, still in the presence of high liquidity, the Treasury borrowed only 44 billion lire at short-term, but as a result of a shift in its sources of finance the Treasury became still more indebted to the banks while it repaid some of its debt to the Bank of Italy. In 1960 the Treasury slightly reduced its overall short-term indebtedness.

As a result of these developments, the share of short-term credits to the Treasury in total credits outstanding fell from 45 per cent at the end of 1955 to 30.7 per cent at the end of 1960.

The annual surplus in foreign payments kept growing until 1959 and then dropped by half last year. At 2,000 billion lire, gold reserves and short-term claims to foreign countries constituted 16 per cent of the total volume of short-term credit at the end of 1960, compared with 6.7 per cent at the end of 1955.

The volume of the private sector's new borrowing from the banks, finally, diminished until 1958. This was a counterpart to the other two sectors' heavy claims on bank credit, but when first the Treasury and then the foreign sector changed course, the private sector's bank borrowing picked up to such good purpose that it more than trebled its 1958 amount in 1959 and then again almost doubled the 1959 amount in 1960 (1,186 billion against 678 in 1959 and 203

in 1958). The proportion of bank credits in the total of short-term credits outstanding grew from 48.3 per cent at the end of 1955 to 53.3 per cent at the end of 1960.

The surplus of total new liquid assets accruing to the private sector over its short-term borrowing, the so-called liquidity surplus of the private sector, amounted to 439 billion lire in 1960, as against 855 in 1959 and 1,030 in 1958.

In 1958, bank loans exceptionally grew less than bank money. This was a reflection of the diminished "multiplying" function of the banking system in the presence of a sharp liquidity increase arising from the foreign sector and a slower rate of growth of production. In 1959, bank loans and bank money increased in almost identical measure, and in 1960, finally, the growth of bank loans far exceeded the formation of bank money as a result of higher economic activity and less liquidity formation through foreign surpluses.

The banking system's primary liquidity reserves (that is, cash, Treasury bills and balances at the Treasury and at the Bank of Italy in the form of voluntary deposits and unutilized credit margins) diminished appreciably both in relation to deposits and in absolute terms. Nevertheless, they were still sufficient for the volume of business. Their percentual ratio to deposits dropped from 11.3 per cent at the end of 1959 to 6.6 per cent at the end of 1960, and in absolute terms primary liquidities fell from 999 to 677 billion lire.

This reduction in the banks' primary liquidity reserves is in sharp contrast with their considerable expansion during the two preceding years. The main reason was the contraction in liquidity emanating from the purchase of foreign exchange; at the same time, the Bank of Italy also increased by a lesser amount its net advances to the banking system. Treasury operations were practically neutral in both these last two years, in the sense that they neither created nor destroyed bank liquidity in any significant measure.

The creation of claims on the Bank of Italy through any of the operations mentioned or through transactions of the Treasury is subject to wide cyclical fluctuations; by contrast, factors that tend to absorb these claims, namely, the expansion of the note circulation and of the banking system's compulsory reserves, behave in a more stable manner. This was proved once more by the experience of the last two years. While total note circulation and compulsory reserves together expanded by something like 450 to 500 billion lire in both years, the creation of bank liquidity due to the operations of the Bank of Italy

and the Treasury declined from about 650 billion lire in 1959 to about 200 billion in 1960. As a result, bank liquidity expanded by some 200 billion lire in 1959 and contracted by about 300 billion in 1960.

No change took place in 1960 in the proportion in which primary and secondary liquidities contributed to total liquid assets. In 1959, by contrast, primary liquidities had expanded much more in relative terms. This was especially true of bank money and can be regarded as a reflection of the distinct change in the cyclical climate. The previous years' tendency to switch over to more durable forms of investment hardened in 1960, when the shift went even beyond the maturity limits of secondary liquidities well into the field of equity and bond investments.

Among the sectors which exercised a demand for money in 1960, the private sector was outstanding. The Treasury maintained a neutral position as a creator of liquidity, and the foreign sector's liquidity deficit was about half as big as the year before. This means that, contrary to what happened in 1959, when the foreign sector played the leading part in liquidity creation, or in 1968, when the foreign and the public sector together took the limelight, the market's increased liquidity demand was, in 1960, met mainly by the banking system's activation of the liquidity reserves it had previously accumulated. This circumstance confirms the alternative functions which, in normal conditions, devolve upon the separate components of liquidity creation, and shows up in particular the high degree of substitutability between the external component and the domestic private sector, according to the shifting pattern of cyclical influences emanating from internal and international trade.

To this observation we might add the other, obvious one, that the expansion of bank credit is limited by the banks' liquidity situation, which in turn depends largely upon the Treasury's and the central bank's operations. It follows with all desirable clarity that an orderly control of liquidity requires constant and close collaboration between the Treasury and the central bank. This seemed perhaps less urgent in the past, when the dominant part in liquidity creation was played by the foreign sector – that is, when large-scale sales of foreign exchange to the monetary authorities created far more liquidity than the operations of the Treasury and the banking system. But collaboration between the Treasury and the central bank is once more assuming its full importance now that the falling balance-of-

payments surplus is reducing the foreign component's relative weight. The shift from foreign sources of liquidity to internal sources is of course, as need hardly be recalled, the result of a change in the order of priorities of our country's economic policy objectives. Having built up our reserves to an adequate level, we can now afford to assign to domestic uses the real resources which in the last three years gave us an export surplus in goods and services, as well as those which we can buy abroad with the proceeds of emigrants' remittances and of other unilateral transfers we receive.

We all know that the strengthening of our reserves, especially in the first few years after the stabilization of the lira, was a matter of paramount importance for the orderly progress of liberalization in the field of foreign trade and payments. Now, if we look from the point of view of liquidity creation at the environmental factors and economic policy measures which did most to help us build up our reserves, pride of place belongs to the sound proportion we kept between the growth of government spending and government revenue, as well as to the Treasury's strict financial practices in covering the budget deficit, which were intended to reabsorb, from time to time, a large part of the liquidity created by the deficit. There can be no doubt at all that the containment within moderate limits of liquidity creation by the Treasury and the at least equally strict principles which the central bank observed in its lending operations have pushed the market mechanism into producing balance-of-payments surpluses and thereby shifting liquidity creation to the external sector. In turn, the balance-of-payments surplus was achieved without imposing unduly deflationary pressures upon the Italian economy, largely because to the said surplus contributed generous unilateral transfers to our country and our exporters' conquest of foreign markets was favoured by the slight inflation which, for the past five years, has reigned throughout the world.

In recent Annual Reports, it has already been noted that liquidity creation through the rapid expansion of the gold and foreign exchange reserves in 1958 and 1959, and through the Treasury's short-term borrowing in 1958, was somewhat in excess of the market's normal needs. This happened because of the limited elasticity inherent to the other internal source of liquidity, that is, because the volume of bank credit did not vary sufficiently in offsetting directions; in 1958 an additional cause was the slower rate of productive expansion.

Equally, it has been noted that the excess liquidity was deliberately not reabsorbed, so that it could bring about a reduction of the general level of interest rates and provide a stimulus for economic recovery. Both purposes were achieved. The years 1958 and 1959 will most likely be remembered in the future as those when, under the additional impact of our country's growing integration in the world economy, the structure of interest rates in Italy finally moved more closely to the levels prevailing in more capital-intensive countries.

Once economic recovery was well on the way and liquidity creation in the foreign sector still continued strongly, the Treasury resumed its financing on the capital market towards the middle of 1959. In little more than six months, in July 1959 and again in January 1960, two Treasury bond issues produced 434 billion lire of new money for the Treasury. This sum was roughly the equivalent of the Treasury's own cash requirements from the beginning of 1959 to the end of the first quarter of the current year. Therefore, all the remaining funds raised by the Treasury in the meantime, mostly through the sale of Treasury bills made especially to the banks, were available for repayments to the Bank of Italy.

In 1961 so far the absolute level of bank liquidity has not shown appreciable changes. In these circumstances, the monetary authorities did not consider it advisable to proceed to any further issues of government bonds, the proceeds of which would, in the current favourable position of the cash budget, have served to destroy liquidity in the same amount.

Looking at the near and not quite so near future, it is safe to assume that the balance of payments will be more or less in equilibrium. The Treasury's present favourable position, on the other hand, may well change when a number of extraordinary expenditure programmes, which are already planned or are being planned, reach the stage of implementation. Given that the Treasury's increased requirements will be predominantly for higher investment, it is to be hoped that when they arise they will be financed in the most orthodox manner, namely by recourse to the capital market. This is the only way to avoid that the public sector becomes a source of inflationary pressure, just as in the recent past it has avoided becoming a source of deflationary pressure.

In the conditions we have described, the central bank may be called upon to regulate the process of liquidity formation by action

also on the other internal component, namely bank credit to the private sector, through the multiplier effect of the increased funds which may be put at the disposal of the banking system. It may happen that the anticipated change in the relative weight of the various sources of liquidity will provide an opportunity for tailoring money supply more closely to the market's real needs. Obviously, any measures of monetary policy which it may be thought right to apply will be put into effect with all due caution, especially with regard to their repercussions on the balance of payments. A balance-of-payments deficit would be acceptable only on condition that it is seen to be the effect of purely transitory causes and therefore strictly related to the short period.

The changes which are taking place in our money and capital market testify to our country's progress towards advanced forms of economic order more in keeping with her new position as an industrial nation, and one of the most dynamic at that. Even so, our economy has, in some cases, run ahead of its own institutions.

These changes also confirm the greater role played by short- and long-term credit in the finance of the domestic economy's development. To finance a process of development in a regime of stable money in an open economy presents the monetary authorities with anything but an easy task.

Conscious as we are of the limits of monetary and credit policy, we are nevertheless convinced that a policy alert to new needs, differentiated in its methods and ready to adapt itself at all times to the shifting aspects of economic life and to the new forms which old problems may assume, is an indispensable supporting and stimulating element in the process of development.

In its time we had the danger of large-scale and open inflation; now we have less eye-catching but for that reason no less harmful varieties of it. In these circumstances the conduct of monetary policy requires a patient and painstaking effort of continuous adjustment both of policy instruments and of their use to the multitude and mutability of the problems at hand.

A monetary policy, which is firm in its ends but flexible in its means and manifestations, obviously requires a high operating efficiency on the part of the money and credit system as a whole. The valuable and fruitful co-operation which banks and other credit institutes extend to the central bank has been in the past and will continue to be the best guarantee of the smooth functioning of the

system, in harmony of purpose with the activities of the central bank, for the achievement of objectives which are common to us all.

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Italy is this year celebrating the centenary of her political unity. The act of unification in 1861 was so momentous an event in the history of our country that other, related, anniversaries are necessarily overshadowed. But we may be forgiven if, in this house, we think it worth commemorating also the birth of the lira, which took place on the very morrow of the proclamation of the unitary state. Nor should we forget that national unity also stood at the cradle of a trade policy intent on opening the Italian economy more widely towards the world market.

This policy, as we know, has had its vicissitudes and setbacks. But we should always remember that the very makers of our unity, conscious as they were of the initial shortcomings of the national production system, always upheld the doctrine that the economy of Italy could draw stimulus and vigour from international competition and that her development stood to gain more from free trade than from protectionist restrictions.

The same principles later inspired our greatest statesmen and were propounded and defended, with scientific objectivity and polemical ardour, by an uninterrupted line of our foremost economists.

The trade liberalization policy of the post-war years has, therefore, a more direct and closer link with Italy's original foreign trade policy than might appear at first sight. It is not by accident that the man who firmly set our country going on the road to freer foreign trade after the war, who dispelled all the recurrent fears awakened by this policy and constantly preached its certain and durable benefits, who had the vision to point the way towards new and bolder forms of international integration – that the man who did all this should have been no less outstanding a scholar than he was a statesman: Luigi Einaudi, whose firm, unswerving and untiring support of free trade is enshrined in an impressive row of published works.

If international competition is indeed the most powerful incentive towards our country's economic development, there can be no doubt that, in turn, its strongest pillar is monetary stability. This, too, is a lesson handed down to us through a century of Italy's – some-

times painful – experiences as a nation state. At the outset, six issuing banks discharged a function of direct entrepreneurship in financing the slow and arduous early stages of development. Slowly they withdrew from this forward position to become the pivots of a new credit system which gradually enriched its structure through institutional evolution. This in turn affected the issuing banks, whose number was reduced to three in the 1890s and eventually to one in the last stage of unification.

Faced with the requirements of the more rapid pace of growth which, towards the end of the nineteenth century, marked Italy's first steps as a modern industrial nation, our original credit system ran into some troubles and occasionally fell into grave excesses, especially during the difficult years of the great depression. When eventually it became imperative to take corrective action, this took the shape of a comprehensive banking reform, which will always be associated with the name of its foremost architect, my distinguished predecessor Donato Menichella.

He has deserved well of his country and of the banking world by carrying through the above-mentioned structural reorganization of our credit system and by introducing into it such changes as the course of economic events called for. Later he earned – and, with truly impressive warmth and unanimity, was accorded – the highest recognition for his astute, swift and firm action to restore the internal and external stability of our currency after the second world war.

Today we can look back and state that, while real income per head has tripled in Italy since 1861, more than half the improvement took place in the years between 1951 and 1960. These are the years when, not least by virtue of new technologies which attenuated some of our economy's structural weaknesses, we attained the goals set by the fathers of Italian unity: our country has at last definitely become a centre of manufacturing industry, firmly established in the great currents of world trade.

Our unity, it is true, has still to be consummated on the plane of economic conditions and living standards in the different parts of our country. Never have we been more conscious of this than in the present centenary year. But for all that it is both a right and a duty for us to give due recognition to the results achieved so far, if only to acknowledge the means which have been given us to make a more decisive attack on this grave and ancient problem. Nor must we fail to learn the lessons which the road we have travelled in the past may hold for our progress in the future.