Concluding Remarks for 1961

Gentlemen,

Hardly two months ago the government's Report on the Economic Situation in Italy laid before Parliament and the nation a broad picture of the course of Italy's economy in 1961. Since then, the government has, in a number of other documents and programmatic statements, made public its own considered view of the problems and priorities to which economic policy in general is to be directed.

In speaking to you today at our annual meeting, I shall regard it as my duty to discuss more particularly the role incumbent upon exchange policy, international co-operation and domestic monetary policy in countercyclical as well as in more forward-looking action. In so doing, I shall dwell especially on the institutions and mechanisms by which monetary flows are channelled into the public sector and private investment.

World Economic Conditions, Co-operation between Central Banks and International Liquidity

For the world's industrial countries generally, 1961 was another year of economic expansion, although individually many countries experienced pressure on prices or on the balance of payments, leading to considerable shifts in their competitive position beyond those following upon the currency revaluations of March 1961.

The United States' overall balance-of-payments deficit, though somewhat smaller than in 1960, was still very large, because the current surplus was not enough to finance the net outflow of short-

and long-term private capital, economic aid to other countries and military expenditure abroad. Canada and other primary-producing countries, on the other hand, had current deficits offset by large inflows of foreign capital. The United Kingdom and the rest of the sterling area were in deficit, though less so than in recent years.

The inflationary pressures experienced by several European countries were, at least to some extent, of outside origin. It stands to reason that, in a system of large-scale foreign trade and generally fixed exchange rates, inflationary pressures generated in any one country tend to spread to the rest of the world, while, conversely, their effect on the price level of the originating country tends to be mitigated by imports. It follows that international price movements and balance-of-payments disequilibria are the two principal means of adjustment for such inflationary or deflationary pressures as may appear in individual countries.

All through the 1950s and still at the beginning of the 1960s, economic policy everywhere was generally of an expansionary nature. By and large, the response was a growth of supply in real terms sufficient to allow the authorities to retain control over prices even in conditions of nearly full employment. In some countries, nevertheless, the policy of sustaining demand has tended more readily to generate inflationary pressures, and the monetary authorities then found themselves faced with the painful alternative of either applying restrictive measures which, in some circumstances, might be apt to lower the degree of capacity utilization and thereby to slow down economic growth, or else of accepting the erosion of money for a certain time, only to clamp on restrictions later.

In other, more favourable, conditions it was somewhat easier to combine monetary stability with growth. From this point of view, the experiences of the last ten years repay close study, in so far as they can teach us much on the basic conditions of success in this matter.

The first lesson is that in the countries most closely integrated in international trade, the conditions of growth are most propitious when the necessary maintenance of a high level of aggregate demand does not conflict with the equally necessary maintenance of a high degree of competitiveness which in turn depends, among other things, on a rise in productivity. Without that essential condition, foreign demand is unlikely to expand in the desired measure or, if it is stimulated artificially, cannot by itself ensure rapid and balanced growth. By contrast, a strong competitive position provides the means

to finance an abundant flow of imports and, through its effects on the strength of the currency, makes it possible to avoid recurring restrictions on demand for the sake of the balance of payments. There is the warning example of the United Kingdom to show how such restrictions depress investment and with it the whole rate of expansion.

It is quite certain that during the 1950s the prospect of strongly rising foreign demand was an important growth factor for many industrial economies. There is more than one reason for this. First of all, the incidence of exports on the net product of industry is relatively greater than that of any other component of global demand. Secondly, the expectation of rising exports has a decidedly favourable impact on the view one takes of the extent to which sustained and growing demand can be met with available resources. And thirdly, these expectations are, in their turn, encouraged by a high rate of expansion, just because of its effect on productivity and hence on competitive strength.

Experience has also confirmed the close correlation between a high rate of expansion and a rapid improvement of productivity, thus proving the conclusions of economic analysis to the effect that self-sustained growth can be generated by rising productivity and expanding export markets. Countries in an initially weak competitive position have had the greatest difficulties in containing money incomes within the limits of a slow improvement in productivity, and this has further weakened their ability to compete and has slowed down growth, thus inaugurating a downward spiral from which it is hard to escape. To try to expand demand in such a situation with the object of raising productivity, to the extent that is necessary to keep costs stable, is indeed exceedingly difficult in the short run, in view of the narrow margins of unutilized capacity and of weak foreign reserves. Conversely, countries in an initially strong competitive position have found it easy to absorb rising wage costs in periods of heavy pressure of demand for capital and labour and hence to maintain a high rate of growth, because a rapid increase in productivity has enabled them to defend or even to strengthen their competitive position.

Despite the greatest efforts, in fact, few countries succeeded during the last ten years in making the transition from a low to a high rate of growth. Nothing could provide better proof of the fact that, quite apart from the purposes and methods of economic policy, the creation and maintenance of competitive strength in international

markets is quite indispensable in the conditions of the modern world.

It must be concluded, therefore, that one of the principal components of growth policy is the removal of foreign trade barriers, which encourage non-competitive activities and make it difficult to penetrate foreign markets. Another is the gradual elimination of those obstacles to the mobility of capital which disturb the international movement of monetary flows and savings. A third point to stress is the need to make every effort, both by autonomous measures and through international collaboration, to even out emergent balance-of-payments disequilibria, especially in the major countries.

Given the great importance which the solution of the growth problems of economically less developed countries has for the whole world, it is imperative that international collaboration be extended to all compartments of economic policy. The experience of the last ten years seems to suggest that the efforts of the developing countries to achieve rapid growth on a sound basis were most successful in cases when it proved possible to avoid inflation, thanks to a supply of savings sufficient to cover the large requirements of the public sector, and to go ahead with the realization of a detailed and concrete development programme.

Nevertheless, even the fulfilment of these two conditions does not appear to be enough to vouchsafe conspicuous progress in the absence of a propitious external situation. Developing countries need not only financial and technical aid, but also a system of international exchange in which they can expand their exports in a satisfactory manner.

As in industrial countries, only more so, the success of growth policy in developing countries is largely conditioned by the balance of payments. Without good export prospects, it becomes almost impossible for them to build expansion plans on economically rational projects or to mobilize the saving needed for projects requiring capital goods which must be paid for in foreign exchange.

All this points to the expediency of planning for economic growth in overall terms, so that limited physical and financial resources may be correctly allocated between alternative uses of different degrees of priority and so that the extent of supplementary requirements to be met by foreign aid may be assessed. It should be added that, in the past, whenever development programmes were associated with a vigorous policy of monetary stability, they

heightened business expectations of the future course of global demand, reduced margins of error and with them the losses which the economic system might otherwise have had to incur.

More even than in 1960, the size and direction of short-term capital movements – whether directly or indirectly connected with commercial and financial transactions or due to purely speculative motives – last year created serious disturbances in the economic relations among industrial countries.

To the extent that money rates are still rising in Europe and, for internal cyclical reasons, still falling in the United States, the conflict between domestic and external needs to which I drew your attention last year must be expected to become yet sharper. I can but repeat that the possibility of such conflicts calls for the creation of adequate compensatory machinery. In 1961 already, the monetary authorities of the industrial nations tried, through close bilateral and multilateral co-operation, to neutralize the effects of hot-money movements and to make advance arrangements to absorb the shock of foreseeable future movements of this kind.

Bilateral co-operation took the form of agreements between central banks, including that of Italy, generally to the effect that some of them might hold in their reserves currencies other than those traditionally used for this purpose. More specifically, these agreements also enabled reserve centres to substitute some of the major convertible currencies for gold in spot and forward interventions on exchange markets. Reciprocal facilities between central banks have the advantage of speed, since they can be put into effect without cumbersome formal procedures; on the other hand, they are necessarily subject to certain quantitative limitations and, even when no definite time limit is set, can apply to the short run only and need to be refinanced with more stable resources in case the original disturbance should persist. Examples of effective central bank assistance are the facilities extended in the spring of 1961 to the Bank of England and, later that year and again in the early months of 1962, to the United States Treasury and Federal Reserve, who now propose to build up some foreign exchange balances of their own.

Multilateral co-operation between the industrial world's monetary authorities, again with full Italian participation, has furnished the International Monetary Fund with supplementary resources of six billion dollars, to be drawn on, if necessary, by countries embarrassed by large-scale and sudden movements of short-term funds. The credits

which the participating countries may be called upon to put at the Fund's disposal by virtue of this agreement are repayable at the lender country's request in case it should run into balance-of-payments difficulties.

Another important result of international monetary co-operation are the agreements between several central banks and the Federal Reserve to lay down good-conduct rules for gold transactions and to co-ordinate gold purchases in London. The purpose of these agreements is clearly to mitigate the threats to international monetary equilibrium which derive from the existence of two channels through which monetary gold requirements can be met, namely, the Federal Reserve and the London market, which latter, incidentally, is the meeting place not only of central bankers but also of industrial users, private hoarders and speculators.

Italy's Balance of Payments

The above general considerations are fully borne out by Italy's economic experiences over the last ten years. Without any doubt at all, productivity was the most important single factor to contribute to the rapid expansion of output in Italy. The same factor enhanced the competitive strength of Italian goods on foreign markets and thereby helped to increase exports at a pace fast enough to create a sound balance-of-payments position and to enable the country to escape at least one category of setbacks and uncertainties which might otherwise have handicapped domestic expansion.

The conspicuous rise in Italian productivity is attributable to the economies of scale which domestic growth and growing integration with world markets brought in their wake, in so far as they permitted the fuller utilization of existing plant and an increase in the size of firms. In the last analysis, that is, the rise in productivity was due to new investment and to the adoption of new and more efficient factor combinations.

Not all countries, of course, start out from the same position, and it must be recognized that Italy was better placed in both respects than most other industrial countries, where for some time past firms have been bigger and the degree of capacity utilization higher.

Another factor to work in Italy's favour has been abundant labour supply, which helped to contain the rise in wages, and provided durable support for such competitive advantages as Italian goods enjoyed abroad thanks to their quality and to energetic sales promotion.

Naturally, all these factors had the strongest impact on those sectors whose outlets were widened by steady foreign demand and where international competition, stimulated by import liberalization, called forth the modernization of obsolete plant and hence a cost reduction.

The view that successful foreign trade is the foundation of lasting domestic growth is certainly confirmed by the Italian experience. Throughout the period 1950-61 exports were the most dynamic component of global demand; they increased at an annual average rate of 13.3 per cent in real terms, whereas investment demand increased by 9.2, consumption demand by 4.8 and total domestic demand by 5.8 per cent on the average over the twelve years.

However, as Italy is gradually closing the gap between herself and the older industrial nations, we witness a diminution of those differences in the rate of increase of productivity and wages which, as we noted, were principally responsible for the rapid expansion of Italian exports.

Neither in 1960 nor in 1961 have the overall balance-of-payments surpluses given rise to corresponding changes in official gold and convertible currency reserves. Part of the surpluses were transferred from the accounts of the Italian Exchange Office and of the Bank of Italy to those of commercial banks, part of them were used to finance drawings on the IMF lire quota, and part of them to buy in Italian securities circulating abroad.

Of an overall surplus of 442 million dollars in 1960, 127 million went into official reserves, 268 million were transferred to the banking system and the rest was used to extinguish foreign debts or grant foreign credits.

In 1961 the overall surplus amounted to 577 million dollars and official reserves increased by 340 million; at the same time, 82 million dollars were spent on purchasing Italian securities circulating abroad, and other official assets abroad grew by 195 million dollars, principally as a result of the International Monetary Fund's lending out lire. These increases owe something also to the fact that, contrary to what

happened in 1960, the net foreign indebtedness of the banking system rose by 40 million dollars.

During the first quarter of 1962, Italy ran an overall balance-of-payments deficit of 94 million dollars (according to foreign exchange statistics), or just about as much as during the corresponding period last year. However, official reserves fell by rather more than that, namely, by 140 million dollars. The main reason was that the Italian Exchange Office again transferred foreign exchange to the banking system.

The banks' net foreign position has hardly changed since the end of 1961. The monetary authorities have been anxious to prevent the banking system from becoming a channel through which hot money can flow into or out of the country, with all the disturbing effects such movements can have on international liquidity and on domestic liquidity formation. Nevertheless, the banks were still in a position to serve their clients with a considerable volume of credits for foreign transactions.

On March 31, 1962, outstanding credits of this kind amounted to 987 million dollars and they were to a large extent financed with foreign currency bought by the banks from the Italian Exchange Office against lire. Spot purchases from the Exchange Office and forward sales to it actually amounted to 664 million dollars at the same date, and the Exchange Office's foreign currency deposits with the banks to 113 million dollars. Adding to this another 5 million dollars of outright purchases by the banks, the Italian Exchange Office in one form or another contributed 782 million dollars to finance foreign exchange credits, the rest being financed by the banking system's own holdings.

But while the Exchange Office's sales of foreign currency to the banks enabled the latter to balance their foreign commitments, it also reduced their lire liquidity by a corresponding amount.

Realizing that some banks were getting into a rather tight liquidity position in the course of 1961, the Bank of Italy stepped in, through the Italian Exchange Office, to ease the strain. What was done was to buy back some of the foreign exchange previously sold to commercial banks and then to redeposit it with them. Transactions of this kind assumed their greatest volume towards the end of last year to relieve the seasonal pressure on bank liquidity; since then they have fallen off sharply.

The traditional methods by which the central bank increases or decreases bank liquidity were in this manner supplemented by a new device, which appears especially useful in the light of the fact that fiscal charges on commercial bills tend to restrict the use of this type of credit, so that the banking system does not always dispose of sufficient quantities of rediscountable paper.

It has been noted earlier that the Italian Exchange Office repurchased fairly large amounts of Italian securities circulating abroad. Altogether, the Exchange Office had in its portfolio on March 31, 1962, securities in the amount of 173 million dollars, 54 million Swiss francs and 19 million Dutch guilders, in addition to 12 billion lire's worth of lire securities optionally payable in foreign currencies.

In January 1962, new provisions entered into force by virtue of which non-resident ordinary and capital accounts became freely intercommunicating in both directions. The effect was to remove any possibility of an unofficial lire rate different from the rate on the official exchange market. Since Italian bank notes reimported from abroad can be freely credited to non-resident capital accounts and, via transfer to ordinary non-resident accounts, transformed into foreign currency at the official rate, bank notes can no longer be quoted at any other but the official rate.

Other measures to give additional freedom to capital movements were taken in 1961, but it has not so far been possible to remove the restrictions on Italian residents' purchases of foreign shares, given the existing differences in fiscal assessment procedures applicable to Italian shares on the one hand, and to foreign shares on the other. Now that a new provision has been introduced under which income tax on dividends is withheld at the source, the extension of the applicability of this provision to foreign shares owned by Italian residents and duly deposited with the banks, may open the door to a further liberalization of equity investment.

During the second half of 1961 and the first quarter of this year, large bond issues were floated on the Italian capital market by the International Bank for Reconstruction and Development, the European Investment Bank and the Inter-American Development Bank. We note with especial pleasure that this was the first issue made by the Inter-American Development Bank and we regard it as proof of the close ties of friendship which, beyond those of an economic nature, link Italy with the nations of the Latin American

continent. Nor is it to be excluded that the provisions of the new law on export credits may in practice lead the special credit institutes to raise on the capital market funds to finance or refinance economic aid to developing countries.

Obviously, the possibility for the special credit institutes to finance both the so-called tied credits – tied, that is, to the export of Italian goods – and untied credits is limited by the need to distribute resources between domestic and foreign claimants. Mediocredito cannot provide more money than it has in its endowment fund, unless it were, itself, to turn to the capital market, where it would come up against the same limitations which the credit institutes also encounter.

As regards the cost of credits to foreign countries, it may, especially in the case of untied credits, seem expedient to keep interest charges lower than corresponds to the conditions of the capital market. But here again it must be stressed that, in case the government should consider such practices to be in the general interest, there is only one proper method suitable for the purpose, namely, adequate government subsidies either on capital or on interest account. It is incumbent upon the central bank to press home the point that to create means of payments cannot, in any circumstances whatsoever, be allowed to substitute for such subsidies; as the guardian of the currency, the Bank cannot evade its primary duty to maintain monetary equilibrium.

Prices, Production and the Sources of Finance

Turning now to domestic monetary equilibrium, we note that, although since the middle of 1960 world raw material prices have had a tendency to fall, on the contrary domestic wholesale prices have recently had a tendency to rise.

During the first quarter of 1961, wholesale prices were stationary; in the second quarter they declined a little and then they started to climb in a more and more pronounced manner. The determinant influence in these movements has come from fluctuations in the prices of agricultural and food products. These prices have been rising steadily throughout the last quarter of 1961 and again since the beginning of this year, and while the increase may have

owed something to a crop failure here or there and, occasionally, to bad weather in vegetable- and fruit-growing districts, it has for the most part taken place in response to high domestic and foreign demand.

Wholesale prices for raw materials and manufactures were subject to some minor fluctuations last year, but the price level as a whole was stable, thanks to the offsetting effects of slightly falling raw-material prices and slightly rising product prices. These conflicting movements go back to the middle of 1960, when the rise in manufacturing costs began to overtake the increase in productivity in some sectors. Between March 1960 and March 1962, raw material prices dropped by 3.6 per cent and the prices of manufactures rose by 3.1 per cent.

However, the stability of the general level of industrial prices throughout 1961 was followed, during the first quarter of this year, by a rise of 1.2 per cent, as a result of a certain slowing-down in the fall of raw material prices and a quicker advance of those of manufactures.

Retail prices and the cost of living have been climbing rather faster than wholesale prices. During the year ending on March 31, 1962, the wholesale price index rose by 2.2 per cent, the retail price index by 3.9 and the cost-of-living index by 5 per cent.

It has been the customary pattern for a long time for retail prices to rise by about 2.5 per cent a year, even in the presence of a stable wholesale price index; but these habitual causes, as it were, were recently reinforced by the slight upward movement of wholesale prices. In the event, the rise in the indices of retail prices and of the cost of living between March 1961 and March 1962 was considerably in excess of the long-term trend.

It is true that food prices, in particular, recently felt the impact of some random causes; nevertheless, there remains an underlying strain in our price system, as a result of high domestic and foreign demand coupled with cost increases tendentially in excess of productivity improvements.

Our economic system again gave proof of its remarkable capacity to expand supply. It is common knowledge by now that the excellent results of 1961 raised Italy's national income by 7.9 per cent in real terms and her production curve well above the trend line over the last ten years of strong expansion. Furthermore, the rate of increase of output speeded up during the second half of the year and more especially during the last few months.

The index of industrial production, the annual average of which rose by 9.1 per cent last year in comparison with the annual average of 1960, stood about 15 per cent higher in December last year than twelve months earlier. During the last quarter of 1961 overall output was more than 5 per cent above the annual average.

Looking separately at the major components of global demand, in terms of current prices and with reference to the last quarter of 1960, export demand is seen to have risen by 22 per cent, domestic investment demand by 16 and consumption demand by 9 per cent.

The value of fixed investment in industry rose by 21.5 per cent between 1960 and 1961. Machinery purchases alone increased by 25.4 per cent over the year.

Nearly all branches of industry expanded their investment last year, but particularly so the iron and steel, engineering and chemical industries as well as petroleum refineries, which together were responsible for more than 45 per cent of total fixed investment in industry.

Although industrial companies, generally speaking, were engaged in large-scale programmes of plant extension, their financial position was on the whole satisfactory, although certain aspects of abundant liquidity, which had been so marked in 1960, began to disappear.

External sources of finance last year furnished industrial companies with 80 billion lire less new money than in 1960, namely, 726 billion as against 806. The contraction was wholly due to the companies' reduced direct recourse to the market in the form of bond and share issues; the drop from 627 billion lire in 1960 to 487 billion in 1961 was not fully offset by the special credit institutes' new industrial assets in the amount of 239 billion lire, as against 179 billion in 1960.

At the same time, industrial investment expanded by 281 billion lire last year, as shown by the national accounts. The cumulative effect of the higher investment expenditure and the reduction in the flow of external funds to the industrial sector works out at something like 360 billion lire; if, in these circumstances, the liquidity position of industrial companies were to have remained the same as in 1960, they would have had to find an additional sum of like amount from self-financing.

This would have implied a further acceleration of the already very high rate of increase of self-financing, but instead the rate of increase slowed down a little. It follows that the investment requirements of industrial companies last year were met by a steady increase of short-term indebtedness to the banks.

This development was more pronounced in the case of the larger companies and those engaged in large-scale extension and modernization programmes. Our usual survey of major joint stock companies in fact shows their gross fixed investment last year to have been 35 per cent in excess of the 1960 figure and therefore well above average. These are the companies which are most sensitive to changes in the financial equilibrium and also those in which rising wages tend to push up labour cost. It is they which have suffered most from the slowing down of the rate of increase of profits available for self-financing.

Housing construction last year absorbed a total of 1,192 billion lire of investment, compared with 1,101 billion in 1960. As a result mainly of the reduction in INA-Casa investment, the public funds reaching the building sector fell off from 223 billion lire in 1960 to 176 billion in 1961. Housing investment financed from private sources correspondingly rose from 878 to 1,016 billion lire, to which the special credit institutes contributed mortgage loans in the amount of 248 billion, as against 142 billion the year before. In its turn, short-term borrowing from the banks increased considerably, especially in the form of credits to construction firms and pre-finance for mortgage loans. In global terms, the inflow of market funds fully covered private investment demand, and private saving directly invested in housing remained roughly equal in the two years at around 600 billion lire annually.

After this brief review of the sources of finance for investment in the two broad sectors of industry and housing, last year's changes in the overall situation of private investment, and sources of finance therefor, will be understood more readily.

As in 1959 and 1960, investment financed from private sources again increased at a higher rate than investment financed with public funds. Private investment rose by 16.4 per cent last year, from 3,454 to 4,022 billion lire, and public investment by 3.4 per cent from 1,292 to 1,336 billion. In comparison with 1959, private investment was up 43.7 and public investment 17.6 per cent.

In 1960 the conspicuous investment increment was for the most part financed by exceptionally large direct issues on the market and loans from special credit institutes (which increased from 629 to 1,224 million lire over the year); in addition, self-financing by firms increased considerably.

In 1961 the situation was quite different. At 1,255 billion lire, external funds were only very slightly higher than the year before, and, if the large increase in mortgage loans is excluded, there was even a slight contraction. On the other hand, direct investment of private saving in housing remained almost stationary and the slowly growing funds of self-financing could make but little contribution towards meeting the higher investment demand. As a result, the net short-term indebtedness of industry to the banks increased and this was in part reflected in the banking system's higher loan/deposit and loan/liability ratios; basically, however, the increased borrowing was backed by higher deposits as a result of an improvement in the income and liquidity position of the consumer public.

In fact, bank resources grew last year at an even faster rate than in 1960, thanks above all to the larger flow of funds into savings deposits, which increased by 14.5 per cent in 1960 and by 17.2 per cent in 1961; at the same time, the rate of increase of current accounts rose from 16.4 to 16.9 per cent.

In connection with the strong expansion of production requiring more working capital and also with the higher demand for funds to prefinance intensive investment, bank assets grew by 20.1 per cent – just a little less than the exceptional rate of 1960.

Notwithstanding the large increase in deposits, the banking system therefore experienced a growing strain, which was relieved, as we already noted, by liquidity injections from the Bank of Italy, mainly in the form of repurchase of foreign exchange against lire.

In this manner, the banking system was kept liquid enough to meet the demands deriving from the system's own growing integration with the whole body of productive activity and trade.

The central bank's policy of sustaining and encouraging a balanced credit expansion found expression in yet another measure. In view of the persisting balance-of-payments surplus and of the satisfactory cash position of the Treasury, it was found possible a few months ago to ease bank liquidity all round by reducing the ratio of compulsory reserves to deposits from 25 to 22.5 per cent.

As in 1960, market liquidity was to a large extent provided by the expansion of short-term credits to the private sector. The foreign sector was responsible for liquidity creation in the amount of 363 billion lire as compared with 269 billion in 1960, while for the third successive year the liquidity effects of Treasury operations were negligible.

Total liquid assets at the disposal of the market, which consist for the overwhelming part of currency circulation, current accounts and savings deposits, increased by 16.3 per cent in 1961, compared with 13.9 per cent in 1960. Secondary liquidities in the form of quasi-money increased proportionately more than primary liquidities, monetary circulation and current accounts together having grown by 15.7 per cent, as against 13.6 per cent in 1960.

With the more rapid rise both of incomes and turnover in 1961, the monetary circulation also increased at the faster rate of 11.8 per cent during the year ending November 1961, as against 8.9 per cent during 1959 and 1960. The exceptional accumulation of holidays at the end of December led to a peak which then flattened out again in January.

By the end of 1961 the monetary circulation had risen by altogether 14.6 per cent, but since then the rate of increase has returned to normal and now keeps in step, at a slightly higher level, with the rate of expansion of output and turnover.

The increase in liquid assets of which we have spoken found its counterpart in a strong rise of the private sector's indebtedness, mainly to the banking system. Short-term credits to the private sector amounted in 1961 to 1,371 billion lire, as compared with 1,189 billion in 1960; the corresponding percentage increases in the two years were 20.6 and 21.7.

The market as a whole may be subdivided into the two broad categories of consumers and producers; the latter, as has already been noted, found themselves in a rather less liquid position last year than in 1960, with the result that their net indebtedness to the banking system increased. The liquidity increments of 1961 therefore accrued entirely to consumption economies, which indeed improved their liquidity position considerably.

The total of money supply and finance funds grew last year by 3,599 billion lire, of which 1,699 billion were attributable to the expansion of short-term credit and the remaining 1,900 to medium- and long-term credit in the form of bond and share issues, loans and mortgages.

Although liquid asset formation was well in excess of the expansion of short-term credit in 1961 – to be precise, by 486 billion lire which were transferred to the capital market – last year's annual expansion of medium- and long-term credits fell short of the expansion of short-term ones.

The Capital Market, the Special Credit Institutes and their Relations with the Banking System

There was some change last year in the relative amounts raised by industrial companies directly on the capital market and those raised by special credit institutes. All in all, the capital market provided roughly 1,300 billion lire in both these last two years, but while equity issues accounted for 37 per cent of the total in 1960, their share dropped to 32 per cent in 1961. Bond issues by special credit institutes were very active and provided 685 billion lire, or 215 billion more than in 1960. Their share in total fixed-interest security issues, excluding Treasury bills, rose from 54 per cent (470 billion out of a total of 877) in 1960 to 75 per cent (685 billion out of a total of 917) in 1961. Conversely, the share of industrial bonds and debentures dropped from 22 to 10 per cent. The government raised money for public investment through the special credit institutes, which placed bonds in the amount of 148 billion lire for this purpose last year, as against 40 billion in 1960.

The special credit institutes' increased claims on the market were a response, in part, to the credit demand of firms in connection with their investment programmes, but in part also to the credit demand induced by the progressive spreading of the system of government contributions to interest charges, as a means of promoting ventures regarded as deserving of public support. To some extent, of course, the institutes' increased fund-raising activity was also a matter of deliberate financial policy, in so far as greater responsibilities devolve upon them when the Treasury uses them as intermediaries.

All in all, the special credit institutes granted new credits in the amount of some 900 billion lire last year, which corresponds to an increase of 24.3 per cent over credits outstanding at the end of 1960. Two-thirds of the increment are attributable to the second half of the year.

Privileged credits, that is, those eligible under Law No. 623 for government subsidies towards interest charges, rose considerably in 1961 and show every sign of continuing to do so this year. The figures were 50 billion lire in 1960, 128 billion in 1961, and at the end of March this year privileged credits outstanding amounted to 212 billion lire, while applications for a total of 435 billion worth of such credits had been approved; this left a balance of more than 200 billion still to be paid out, half of it by the three southern institutes.

The outlook for this year is that special credit institutes will again exercise a rising demand for capital funds, especially through bond issues. They will need these funds to meet the claims made upon them by public investment for economic and social purposes, by the foreseeable volume of privileged-credit demand induced by the government subsidies to interest charges, and by the expansion of credit to industry and to foreign countries in the various admitted forms.

The cross-currents between special credit institutes and the ordinary banking system have been assuming growing importance. During the last two years, when the activities of the special credit institutes expanded so fast as to raise their operations by more than 1,500 billion lire, banks and banking associations stepped up their supply of funds (by 208 billion in 1960 and by 315 in 1961) to about one-third of the additional resources needed each year by the medium- and long-term credit institutes.

But there were some internal shifts last year, both as regards the type of funds provided by the banking system and the form in which it provided them. Bond issues for Treasury account increased, and so did the banking system's subscriptions to them. Furthermore, the banks furnished increased amounts through overdrafts on current account, thereby largely prefinancing bond issues, in so far as the overdrafts bridged the time gap between the date of issue and the moment when the proceeds technically became available.

On the other hand, banks and banking associations provided a smaller share – 31 per cent as against 37 in 1960 – of the resources required for the special credit institutes' ordinary operations, excluding, operations for Treasury account and stockpiling finance. Even so, the banks provided more for this purpose in absolute figures, namely, 254 billion lire as against 219 in 1960. In the aggregate, the funds transferred by the banks to the medium- and long-term credit sector amounted to almost one-tenth of total bank resources at the end of 1961.

It may be of interest to note the growing tendency to extend the faculty to issue bonds against long-term loans to credit institutes and special bank sections so far lacking this faculty. The result is that, in spite of the increased absorption or short-term funds by the medium- and long-term credit sector, the separation of the latter from ordinary credit is ultimately reinforced. The wider and more functional structure of the special credit sector, which has grown so much since the war, contributes much to the interregional mobility of capital – to some extent also with the help of the branch network of the big banks which, together with their special credit sections, permeate the whole national territory.

The large bond issues of 1961 had a distinctly depressing effect on bond prices, which are now back to the level of late 1959. Only government bonds improved slightly; the rest declined and have still been giving way since the beginning of this year.

In the light of current prospects, what is needed above all is clearly that the capital market should be flexible; in other words, it must be easy to transfer funds from one category of uses to another and to channel them to those uses which appear most in the general interest. We need measures, therefore, to heighten the response of the market and of market rates of interest to the lead given by the monetary authorities. This means, in effect, that we need to tie short rates more closely to medium and long rates and to create in our country a money market in which the Treasury, the central bank and the banking system interchange funds at variable prices, according to the balance of supply and demand. The purpose of such measures is to improve the machinery through which the money and capital markets interconnect and to enhance the interdependence of the respective rates of interest.

But, ultimately, security issues cannot be placed elsewhere than with savers. It follows that the size of new issues must be tailored to the foreseeable supply of new saving. The investigations which precede new issues will have to become more selective without, of course, any presumption of wishing to lay down the direction of total new investment – of which, after all, only about one-quarter is financed through the capital market. The broader task of deciding upon the distribution of the country's whole resources will be incumbent upon those authorities which are responsible for general planning.

Security issues will, of course, be easier to place in the measure in which the dimensions of the capital market grow. Furthermore, even wide fluctuations in the volume and composition of the total of securities outstanding on the market will be more readily acceptable once the domestic capital market is in communication with capital markets abroad.

All this underlines the need for a policy to enhance the flexibility of the capital market, so as to fashion it into an efficient instrument of finance for a process of steady and self-sustained growth. It would not fit into such a policy to fall into the trap of believing that balanced growth can be promoted through a limitation of the public authorities' discretion to authorize or not to authorize new issues in the light of market conditions. Nor would it be right to expand the system of privileged credits unduly. In our view, credits of this kind are a proper policy instrument so long as the purpose is to even out certain unbalances; but we also believe that, just because privileged credits are a means to correct unbalances, they should be applied in a selective manner, that is, concentrated in the regions and sectors which need special incentives. Applied indiscriminately, they would fail to serve the purpose for which they were intended and would merely become a factor of rigidity on the market.

The need for a well-functioning and flexible capital market is underlined by considerations based on international comparisons, such as were conducted very thoroughly by the Bank last year.

It must be said that the Italian – and, for that matter, the German – capital market has shown reserves of strength which has allowed it to grow more vigorously than the capital markets of other countries. If we measure the size of a capital market by the relevant flows, our expansion over the last ten years was more than fourfold. In Italy, the ratio of security issues to fixed investment was 26.9 per cent during the three-year period 1959-61; in Germany, the ratio was 14.4 per cent, in France 11.3, in the United Kingdom 9.6, in the Netherlands 13.5 and in Belgium 31.9 per cent. It follows that in Italy the market in which security issues are placed has furnished far and away the largest proportion of the capital used for fixed investment, with the sole exception of Belgium, where government and other public agencies were responsible for the high level of security issues.

Similar conclusions can be reached by measuring the size of the capital market in terms of gross domestic product. Again, it will be

seen that during the period 1959-61 the proportion of the latter transformed into fixed investment by the capital market was larger in Italy than in any other country, namely 6.2 per cent, in comparison with 3.4 per cent in Germany, 2.0 in France, 1.3 in the United Kingdom, 3.3 in the Netherlands and 5.6 in Belgium. Time series of the same ratios show that the upward movement was strongest in Italy. All in all, our capital market has demonstrated singular vigour and has proved its worth as an effective instrument of a policy designed to expand investment.

International comparisons also show that the amount of funds passing through a country's capital market is highly sensitive to cyclical influences, tending to grow in periods of rising incomes and to contract in recessions.

Over the last ten years, all categories of issuers of bonds and shares have exercised a strong, if fluctuating, demand for funds. The total of issues has always been determined to a conspicuous extent by the claims made on the market by those categories which have no other way of raising funds except by the issue of fixed-interest-bearing securities. The latter, incidentally, have almost everywhere been the predominant instruments, with the sole exception of France, and have accounted for 70 per cent or more of total issues in most major capital markets.

All this, however, still leaves unimpaired the dominant position of shares in the composition of the total value of securities outstanding; on the contrary, thanks largely to the prevailing trend of stock market prices, the proportion of equities has risen in most cases. In any event, the distribution of security ownership differed widely from country to country at the end of the period under consideration.

A last important point that emerges from international comparisons is that in some countries the banks sustain the bond market with large funds. In Germany, for example, the ratio of bank investments in fixed-interest securities to bank deposits amounted to 12.1 per cent at the end of 1961. In the United Kingdom the banks' portfolio of government securities has been contracting in relative terms and amounted to 19 per cent of deposits at the same date.

All in all, in the international context the Italian capital market is seen as one whose part in financing investment and hence economic growth can well stand comparison with that played by the capital markets of the most advanced countries. Its expansion can therefore hardly be expected to proceed at the fast rate of the past. It is also

true to say that the banking system's support of the stock market, calculated in terms of the ratio of bank investments in fixed-interest securities either to bank deposits or to total security circulation, is rather high in Italy in comparison with other countries.

Finally, we should learn the lesson that, just because the Italian capital market has become an efficient instrument, the monetary authorities cannot and must not evade the heavy responsibility of keeping it in sound condition or even of improving upon it. But no capital market in the world could ever provide hospitality for large bond issues unless the government's policy created confidence in monetary stability.

The Money Market and the Banking System

Last January, as I have already recalled, we lowered the compulsory reserve ratio. This was fully consistent with a line of monetary policy which my predecessor, Dr. Menichella, defined as early as 1949, when he said: "The instruments which we have created and applied, at times, for certain purposes, must be ready to be applied also for opposite purposes" – a point which he drove home more than once in recent years. With this measure we have set free about 200 billion lire, and in our view this should allow bank credit to expand about two-and-a-half times as much. We took this step in the conviction that our balance-of-payments position will remain such as to permit an expansionary measure apt to enable the credit system to give further support to the economy's growth without pushing up interest rates. Given the rising tide of rates in other countries, it was our intention, among other things, to contain the rise of interest rates in the bond market.

The measures by which short-term rates can be controlled are more effective in regulating economic activity in general when they are seen to have an impact also on long- and medium-term rates. The money market must be so organized that this can happen, and only when it does will the changes in bank liquidity due to the change in the reserve ratio have their full effect.

Furthermore, it is only when money rates respond promptly to liquidity changes that it becomes possible to promote such flows of

short-term capital towards or from foreign countries as may be required to compensate balance-of-payments disequilibria.

Suppose, for example, that some country has large balance-of-payments surpluses and that the monetary authorities create a corresponding volume of liquidity. When this additional liquidity comes to weigh on the money market, it immediately brings down money rates, with two results. Part of the excess liquidity is transferred abroad in search of higher money rates, and the reduction of interest rates spreads from the money to the capital market, where the resulting lower capital costs have an expansionary influence on investment decisions. But in the absence of prompt repercussions on long rates, fluctuations in the short rate would have an effect only on international monetary movements.

We believe it essential that we should bring every effort to bear on the maintenance of an efficient capital market on which to place new issues which, subject only to minor price fluctuations, provide the necessary capital funds for the large-scale investment programmes of both the public and the private sector. In pursuing this objective, we have in mind the experiences of others, especially in so far as they go to show that an increase in the quantity of easily monetizable securities often weakens the effectiveness of monetary controls.

Nor must it be overlooked, in planning for a sound money and capital market, that in the Italian banking system as it is at present there is no functional relationship between Treasury bill issues and the Treasury's cash needs. Excess liquidity simply flows into the Treasury, and the balance of its current account with the Bank of Italy is apt to convey a false picture of financial ease.

It should be added that to issue Treasury bills in unlimited quantities and at a rate of interest fixed for long periods, may, at times of abundant liquidity, reduce the incentive for the banks to look for productive employment of their resources, precisely because the banks can invest their liquid funds at will in a security which can always be transformed into money and from which they obtain a constant yield not immediately subject to the influence of changing market conditions.

The present system, therefore, reduces the incentive to adjust the rate of productive lending to the level of liquidity which the monetary authorities think it right to leave on the market; but it also prevents the Treasury from borrowing at interest rates in line with the balance of supply and demand on the money market.

In these circumstances, we believe it would be of advantage if the authorities responsible, together with banks and banking associations, were to consider some change in the present system of unlimited Treasury bill issues, independent of the Treasury's cash needs. The present system might well be replaced by another, in wide use abroad, under which Treasury bills are issued periodically and in quantities corresponding to the Treasury's cash needs. If liquidity is abundant, rates of interest will fall; in the contrary case, they will rise. If the monetary authorities should wish abundant liquidity to bring down the yields of medium- and long-term securities, this will be facilitated by the fact that bank resources, no longer able to flow to the Treasury in unlimited quantity and at constant yield, will instead reach the current account of the central bank, where yields are minute. As a result, banks will have more immediate incentives to look for more fruitful employment of their funds, which may then well be channelled into medium- and long-term securities.

The best innovation to introduce might be to replace the present system of tap issues by monthly quotas. The issue price of each monthly quota would, as a general rule, be aligned to bank rate, and at that price the banks could obtain all the Treasury bills they needed to fill up their compulsory reserves. Anything left over could then be taken up by the banks either as investment for their own liquid reserves or on behalf of their clients. The quotas would be allocated to the highest tenders.

Our credit system is adequate to ensure the flow of funds from one part of the country to another; the big banks, which operate all over the country, move sizeable funds into the less developed areas. Excluding southern banks, the big banks' loan/deposit ratio in the mainland south was 76.7 per cent in 1960 and 77.7 per cent in 1961, whereas the same banks' loan/deposit ratio over the country as a whole was 75.4 and 76.7 per cent, respectively. The divergence becomes even more evident if the islands are taken into account. The big banks' loan/deposit ratio in Sicily was 108.3 per cent in 1960 and 108.9 per cent in 1961; in Sardinia, it was 86.8 and 92.9 per cent respectively. The ratios are lower if southern banks are included in the computation, but then they refer to the lending operations of the banks as such, without their special credit sections. Including the latter, it would seem that the southern banks generously fulfil their task of helping the economy of their own regions.

Another part of the country where loan funds tend to concentrate is, obviously, Lombardy, where the loan/deposit ratio of nation-wide banks was 86.5 per cent in 1960 and 88.0 per cent in 1961. However, the statistics of the geographical distribution of credit do not tell the whole story of the ultimate destination of the credits granted. Milan, for example, is the headquarters of a large number of nation-wide companies. The head office takes up the credit, but the borrowed funds may then be spread all over the country. We do not have the necessary statistical materials, as yet, to determine the geographical distribution of credit flows with a sufficient degree of approximation, but at least we know that we would go seriously wrong in interpreting these statistics as true indicators of the ultimate destination of the credits granted.

Apart from moving flows of money across the country, our banking system also has facilities for large-scale internal movements of funds through interbank accounts. The magnitudes involved are really large now. On December 31, 1961, the total of funds which all categories of banks, except the six largest, had deposited with other banks amounted to 1,077 billion lire; at the same date, the same banks, again without the six largest, had themselves 530 billion lire in interbank deposits. The rest had gone to the six largest banks.

Clearly, the smaller banks, and especially those operating in only one province or region (the former had deposited 255 billion and received deposits of 46, and the latter had deposited 291 billion and received deposits of 82) have more funds than they can employ directly, and the big banks, with offices all over the country, act as depositories for a sort of central cash pool for the smaller ones by lending out not only their own funds, but also part of those which the smaller banks collect.

This puts two heavy responsibilities on the shoulders of the big banks. One of them is that they must at all times maintain a sufficiently large and flexible cash reserve to discharge the tasks which the smaller banks seem to shift onto the big ones by such deposits. In this, we believe, the big banks have not failed. Liquid bank assets in the form of Treasury bills are almost entirely in the hands of the six big banks. This explains why the central bank at times came to the rescue more particularly of these banks by recreating lire liquidity through the repurchase of foreign exchange. It was by no means a case of trying to bolster the big banks' competitive position vis-à-vis the small and medium ones, but of

enabling the former to administer efficiently the cash pool entrusted to them by the latter.

The second responsibility is that the big banks must not pay for the smaller banks' deposits a rate of interest high enough to push up the cost of borrowing for the whole banking system. These interest rates should move parallel with money rates; if, then, the central bank wished abundant liquidity to bring down money rates in order to provide an incentive for the productive employment of bank resources, the big banks which administer the joint cash pool ought to follow suit.

All this suggests that it will become necessary to tighten control over interbank accounts if we are to create a well organized money market, in which money flows become more mobile and in which the conditions of borrowing and lending respond readily to the intentions of the monetary authorities. I do not mean that we wish to suppress the phenomena which come about through the intermediary of interbank accounts. But, should we ever become convinced that the flows moving through this channel carry with them the seeds of a general rise in the cost of borrowing in contradiction to the monetary authorities' intentions, then we shall not hesitate, among other measures, to insert ourselves into these flows.

Our policy with respect to interest rates, both for borrowing and for lending, has always been to prefer those types of restraint which work through agreements among the banks themselves. We have no intention of suddenly adopting the kind of intransigent attitudes for which we sometimes chide our colleagues in the banks, and we shall resist the proposals, which are often made to us, to adopt coercive controls which, in our view, are humiliating both for those who impose and for those who are subject to them. On the other hand, we shall not shrink from using the instruments which modern monetary policy puts into our hands, because we believe them to be more effective than admonishments and threats. In any event, we have every confidence in the reasonable behaviour of bank managers faced with narrow margins between cost and revenue.

The narrowing of the margin between borrowing and lending rates is bound, from time to time, to engage the attention of even the busiest bank manager, but it is also the most eloquent possible demonstration of the existing keen competition in the banking world. If we compare effective debtor and creditor interest rates in the case of some of our big banks and in that of comparable credit institutes in

foreign countries reputedly more open to competition, the spread is probably narrower in Italy. We hope to carry this investigation further with the help of some other central banks and through the exchange of confidential information; but even such fragmentary material as we have at hand allows some reasonably reassuring conclusions.

The further extension of the branch network of banks is another matter where we would wish some self-restraint to be introduced by agreement within the banking associations. We continue to believe that this is the method which can best protect the system against outside influences and ensure a balanced distribution of various categories of banking institutions, such as to make room for the coexistence of decision centres at differing removes from headquarters and thereby to avoid the drawbacks of excessive concentration. But should the banks, by ill fortune, fail to come to an agreement, we shall again not shirk our responsibilities, and the choices we shall be called upon to make will obviously not be uninfluenced by our judgement of the individual banks' willingness to toe the line.

Our economy is now much more mature than it used to be and this must eventually be reflected in the credit system. In common accord we shall have to fashion instruments of monetary and financial policy fit for a country intent on further progress and on making good use of the fruits of progress.

From what we have said before, it will be evident that our success in creating a continuously expanding capital market, the banks' support of the capital market, our steady improvement in the organization of our banking system and credit institutes and their mutual collaboration, have given us what we may rightly call a modern credit system. It is, of course, still in evolution and certainly not free from elements of emulation, and we all want it to continue on the road of progress. On our part, we count, as before, on your whole-hearted collaboration. Our preferred method is that of open discussion and, through it, of mutual persuasion. Even more than in the past, we hope to avail ourselves of your counsel, but on occasion we shall have to call upon your good will in complying with a discipline not imposed, but freely accepted in view of its fitness to further the common weal.

We have outlined the developments which we believe to be apt to safeguard the proper functioning of the capital market and to

create an efficient money market. We have done so because these objectives cannot be realised in practice without the full and deliberate collaboration of those who operate in the fields of credit and finance.

But a word of warning may be indicated. To say that valuable contributions can be made through the improvement of suitable instruments and through the search for every promising opening for their application does not mean that we may lose sight of the fact that these contributions as such can in no way make good any weakening or disappearance of the basic conditions of a continued high rate of growth.

Other countries' experiences go to show that one of the essential determinants of a high rate of growth is a strong competitive position in foreign markets, to be achieved primarily through notable productivity increases.

These lessons are confirmed by Italy's own experience, both as regards the conditions which have allowed our goods to establish themselves abroad and as regards the primary importance which foreign demand has assumed in the last decade as an element of support for the Italian economy.

At present, there is a process afoot in our economy which tends to raise labour costs more than productivity. At stable price levels, this compromises our firms' self-financing capacity and ultimately heightens their dependence on outside sources of finance, as is clearly evidenced by their greater recourse to bank credit. The same tendency is apparent in the growing loan applications to special credit institutes.

At the same time, the volume of investment planned by the public sector in excess of its own saving tends to expand, so that the public sector, too, has to incur more debts. These again largely converge upon the special credit institutes, which cannot, in their turn, pay out more funds unless they float more bond issues in the capital market. If both company saving and public saving are insufficient for expanding investment, there is obviously only one way to re-establish equilibrium, and that is to raise private saving. This has in fact happened to some extent in 1961.

However much our capital market may have grown, it cannot gain immunity from the repercussions of large disparities between the rate of increase of investment, on the one hand, and of the rate of increase of self-financing funds, on the other. This holds especially in

so far as the capital market is, for institutional and conventional reasons, qualitatively subdivided into several, and only partly intercommunicating, compartments.

Furthermore, changes in the composition of investment together with the nature of the investing agency may create sectoral imbalances on the capital market. The nature and size of some agencies lead them to look for funds primarily on the capital market, and to do so, moreover, by means of specific security issues; if investment by such agencies should grow relatively more, then the particular compartment of the capital market involved may experience serious difficulties even if the additional claims on it are not so large in the overall view.

I have described the means by which we propose to improve the flexibility of the capital market and to facilitate the transfer of funds from the money to the capital market; but these measures can obviously resolve only short-term problems and cannot make good any deficiency of real saving. Should inadequate saving fail to be compensated by a scaling down of investment, the measures we have in mind would simply impose a strain on monetary equilibrium. We do certainly have the intention of putting at the disposal of the economy an efficient market where capital circulates freely and can be channelled into the most productive uses, or at any rate into uses in line with programmes considered to be in the public interest; on the other hand, we shall do nothing which might interfere with the level of liquidity at the cost of blurring the dividing line between liquidity and saving.

To sum up, I would say that, while the process of financing production and investment may derive great benefits from the existence of an efficient and flexible market capable of overcoming partial and sectoral disequilibria, this process is ultimately conditioned by real factors pertaining to the primary sources of the formation of saving. In the last analysis, the process remains in the safekeeping of the nation's willingness to save and of a sagacious apportionment of the private and the public sectors' needs with a view to containing them within the limits of disposable saving.