Concluding Remarks for 1962

Gentlemen,

The considerations which I propose to put before you draw their substance from the whole body of our Report on the year 1962 and its detailed description and analysis of economic and especially monetary conditions.

Costs, Prices and the Balance of Payment

The year 1962 was one in which the distribution of income among the factors of production underwent considerable modifications in Europe, and in Italy more than elsewhere. The share of labour increased to the detriment of the share of other factors, not without disturbance to the relations between employers and workers. Hand in hand with the redistribution of incomes went a rise in their nominal value proportionally larger than that of goods and services.

The monetary authorities had the choice of adapting the economy's liquidity to the requirements deriving from higher incomes, including all or part of their price component in the shape of the cost-induced price rises, or of restricting credit to the amount necessary to finance production at constant prices, even if this meant that some firms might have to close down production.

To accept the responsibility of financing cost increases which were bound, at least in part, to spread to prices has involved us in exceedingly complex problems and difficult decisions. The central bank played its full part in taking and implementing these decisions. But we have no ground for complacency: while we succeeded in maintaining a high level of production, we did not succeed in the no less important objective of keeping prices stable.

Wholesale prices, which had remained remarkably stable until August 1961, subsequently displayed a pronounced upward tendency. At first the rise was confined mainly to agricultural prices, but more recently non-agricultural prices took the lead. The general level of retail prices rose by 6.5 per cent between the end of 1961 and the end of 1962, and in the early months of 1963 it climbed even faster owing to the exceptionally hard winter. Spreading beyond food, rents and services, the retail price rise eventually reached manufactured products, which had resisted longest.

If we go back over ten years to 1953, the statistics clearly outline the successive stages of the initial increase in productivity, the rise in profits and their use to finance new plant, which in turn raised productivity still further and was followed, finally, by rising wages. As we approach the most recent period, the pattern becomes more complicated and less easy to interpret, in so far as the wage rise sometimes fell short of the increase in productivity and sometimes exceeded it, with the result that profits fell, cost increases were passed on to prices, and more credit was needed for the same level of investment.

The very expectation of price rises, especially if it rests on a demand expansion manifestly incapable of being satisfied by a corresponding expansion of supply, induces employers to be generous in their wage concessions to workers.

In some cases wage increases originated in the private, and subsequently spread to the public, sector. In some cases it was the other way around, and the propagation of originally public wage rises to the private sector, much the largest employer of labour, occasionally diminished the competitive capacity of private firms to the point of impairing their ability to maintain the level of employment. Here again the time sequence is hard to establish. Nevertheless, we cannot avoid the conclusion that if government-controlled agencies and companies neglect their duty of economically rational management and have easy access to credit, the very expansion of the area of public enterprise implies a danger of dual wage policies, which would be prejudicial to balanced development in the economy.

Cost-induced price rises can, of course, happen only to the extent that the monetary authorities increase the money supply to meet demand. This statement means that the causal chain leads from higher wages and prices to a larger money supply and not in the opposite direction. In other words, in the system of monetary equilibrium wages appear as an autonomous variable: if they rise ahead of average productivity and are not offset by falling profits, the wage increase spreads to prices if it is financed by a larger money supply. If higher wages are offset by lower profits, it may happen that the resulting new distribution of income depresses the level of investment.

This interpretation of the causal relationship between costs, prices, profits and money supply does not mean that, for our part, we take a passive view of the functions of monetary authorities in the sense that they must necessarily supply the economy with all the liquidity it demands. On the contrary, last year's events in many countries testify to a stiffening resistance on the part of monetary authorities against financing a cost-induced rise in prices.

As regards ourselves, we did not think it right to apply restrictions, because in our judgement there were sufficient margins of manpower to combine with other factors of production, and increased imports of resources would absorb our balance-of-payments surplus. Our choice of the manner of our liquidity injections was dictated largely by its foreseeable effects.

In spite of the existing margins of elasticity in domestic supply, the latter proved unable in some cases, such as building and foodstuffs, to meet growing demand. As regards food in particular, weather-conditioned crop failures caused some major items to be in such short supply that even the easing of imports could not make good the deficiency. This was another source of unusually large price rises which, although their causes were localized and transitory, were quickly propagated through the mechanism of sliding wage scales.

In some sectors the strain on prices was aggravated by the converging effects of domestic and foreign demand. A clear case in point was again food, where prices felt the impact of a redistribution of incomes not only at home but also abroad, as well as the repercussions of the European Economic Community's common agricultural policy.

To sum up, the monetary authorities fashioned their policy last year to two circumstances: first, the increase in labour costs per unit of product and the resulting rise in prices, and second, the balance of payments, which showed a surplus during the first half and a deficit during the second half of the year, and on balance still a surplus for the whole year. In these circumstances, the monetary authorities, while injecting liquidity into the economy, did not inject enough to finance the whole of the transfer of the cost increase to prices, leaving part of it to cut into profits. They did inject enough liquidity, though, to prevent stoppages of production in any sector, and incidentally so allowed domestic demand to expand in excess of domestic supply and thereby to mop up part of the current surplus in the balance of payments.

Now, in 1963, the monetary authorities find themselves in the presence of persisting price strains and of a balance of payments in deficit on current account, almost exclusively by reason of merchandise imports growing much faster than exports. It it not only that we see definite symptoms of our own products being less competitive on foreign markets, but foreign products are beginning to be more competitive at home. Our increased purchasing power makes us absorb imported goods more readily. With open lines of communication between the domestic and the foreign market, domestic liquidity flows out to international markets.

In addition, Italy was a capital exporter in 1962 and even more so this year. Capital movements constitute a part of our balance of payments which we cannot afford to overlook, and for this reason we have made special efforts to trace them as closely as possible by assembling all possible information and estimates on the transfer of Italian capital to foreign countries.

In all, the entire set of capital movements which have a bearing on the balance of payments produced a deficit of 152 billion lire in 1962, compared with a surplus of 43 billion in 1961. The deficit was fully offset by surpluses on current account, so that we still had an overall surplus of 31 billion lire. But if we look just at the last quarter of 1962 and the first quarter of 1963, we find a current deficit of 125 and a capital deficit of 151 billion lire, so that we had an overall deficit of 276 billion in six months. This is a sharp deterioration in comparison with the corresponding quarters of 1961 and 1962, when the external accounts just about balanced.

On March 31, 1963, official reserves of gold and convertible currencies amounted to 3,326 million dollars; first-line reserves (official reserves plus the Bank of Italy's net foreign assets) together with second-line reserves (net position with the International Monetary Fund plus the counterpart of swaps with foreign central banks) amounted to 3,831 million dollars. Official reserves covered about seven months' worth of imports, and first- and second-line reserves about eight months.

However, in appraising the adequacy of our official reserves we must think also of the level of domestic liquidity, which gives us the measure of the potential expansion of domestic demand. To the extent that it could not be satisfied by domestic supply, it might, of course, pull the balance of payments further into deficit. Higher domestic liquidity requires higher external liquidity, that is, more official reserves. At the end of 1962, the ratio of official reserves to primary liquidities was 21 per cent, as against 26 and 25 per cent at the end of 1960 and 1961 respectively. This fall in the ratio restricts the monetary authorities' freedom of action on the domestic and on the international plane alike, in the latter case with special reference to aid to developing countries.

Italy stepped up her contributions to developing countries from 239 million dollars in 1961 to 416 million last year. This corresponds to one per cent of gross national product and is more than enough in the light of the high domestic need for savings. We cannot do more in the absence of rational co-ordination of development aid, which seems to be as far off as ever, and in the absence of more multilateral methods of distribution and of closer controls over the use of these funds in the beneficiary countries. Some of the major industrial countries are wont to indulge in international comparisons to underline the relative size of their own contributions, but this can mean but little so long as development aid continues to go to the donor country's former colonial territories or to nations with which it has special political or economic ties.

We wish to stress that aid to developing countries is a responsibility of government and must be financed by budget appropriations; it is inadmissible to finance it by monetary resources, even as a temporary stop-gap pending budgetary provision.

Let us consider now more particularly the short-run problems of international liquidity, which, in effect, boil down to defending the reserve currencies. Clearly, it is the duty of the countries responsible for reserve currencies to achieve a lasting equilibrium in their external payments as soon as possible and in the meantime to contain the deficit within limits compatible with the rest of the world's desire to hold such currencies. Equally clearly, other countries have a duty to conduct themselves as good creditors, though this obligation cannot possibly involve indefinite commitments. So long as Italy's balance of payments was in surplus, we fully lived up to our responsibilities by helping to build effective defences for the international monetary system within the framework of the International Monetary Fund, the European Monetary Agreement and bilateral agreements with the Federal Reserve System and the United States Treasury. Our actual or potential contributions on this score add up to something like one billion dollars or more.

The defences built up by international action are amply sufficient to finance the needs of reserve-currency countries in the near future. There is no urgency at all to strengthen these defences, at any rate until they have been tested; what we need to do urgently is to make them more efficient by working out, amongst ourselves in the European Economic Community and in the wider group of industrial countries generally, a common policy with respect to the composition and management of reserves.

Our country, then, has not been laggard in helping to solve the problem of short-run international liquidity. If anything more should be required of us in this line, we consider that the only possible form would be an increase in our IMF quota. Simple comparison with other major industrial countries makes it quite clear that our quota is indeed altogether too low in relation not only to our country's economic importance, but also to its commitments to furnish supplementary resources. What is more, an increase in our quota appears indispensable in order to replenish the Fund's lire resources, which are now down to working balances. Finally, given the present deficit in our balance of payments, recourse to the International Monetary Fund is not to be excluded, and the amount of possible drawings depends, of course, on the quota.

The Control of Liquidity and its Internal Distribution

The Treasury and the Bank of Italy last year created liquidity in an amount of 591 billion lire. These financed a liquidity increase in the economy of 390 billion lire in bank notes and coin, net of the cash holdings of the issuing agencies and commercial banks; of the rest 171 billion went to finance the increase in the compulsory reserves of banks and the residual 30 billion represent the change in bank liquidity.

The liquidity injection to the banking system had its counterpart in an increase in the public's liquidity, in the form both of bank deposits and of bank notes and coin. As is well known, the process of credit creation which leads to the growth of bank deposits can go on so long as the banking system has enough liquid resources to effect its payments into the compulsory reserve accounts and to keep in hand whatever is judged necessary for the proper conduct of business.

The expansion of bank credits and other investments, and the corresponding growth of deposits, last year required about 397 billion lire to be paid by the banks into the compulsory reserve accounts. The reduction of the reserve ratio with respect to existing reserves provided 226 billion of this total, while the rest was borrowed from the Bank of Italy. Ultimately, as mentioned before, the effect was to raise bank liquidity by 30 billion lire.

The Treasury's transactions with the Bank of Italy and the market, the Bank of Italy's dealings in government securities, and the operations of agencies which act on behalf of the Treasury – that is, accept deposits which are then paid into the Treasury's accounts with the Bank of Italy – have all been combined with each other and with the central bank's other operations in such a manner that their total liquidity effect should be in line with our policy intentions.

Obviously, the chances of arriving at appropriate combinations of the various cash operations of the Treasury depend on the size of the budget surplus or deficit. Unless the orders of magnitude involved are compatible with the requirements of liquidity control, it is difficult to make the whole set of the Treasury's cash operations fit flexibly into the tactics of monetary policy.

So far, the flow of budgetary revenue and expenditure has always been such that it was possible to finance the Treasury's cash deficit by operations which, combined with those of the autonomous agencies, did not exceed the limits within which the economy's liquidity could be made to match the intentions of the monetary authorities. It is not unlikely, however, that the Treasury's cash deficit may grow, and if it does, we may find it more difficult, or indeed impossible, to manoeuvre in this way. We would then have to reconsider the whole problem of the size of the deficit and of the type of securities by which to finance it, and we may well find it necessary to cover the deficit by government bond issues.

The composition of the public debt was rather different in 1962 from the year before, as a result of the greater use of methods of finance which create bank liquidity. The proportion of long-term debts fell from 32 to 29 per cent, and the proportion of short-term debts to the Bank of Italy rose from 13 to 16 per cent. The share of Treasury bills declined, and that of Post Office savings rose, but the investment of these savings by the Central Post Office Savings Fund kept the latter's position neutral.

The new system of issuing Treasury bills by monthly tender in amounts adjusted to the Treasury's cash needs has proved satisfactory. The Treasury fixed its issues so as to reabsorb almost the whole of its credit balance in current account with the Bank of Italy. This was the correct procedure: if due proportions are maintained among the Treasury's cash operations and between them and the Treasury's cash needs, the effect should be to keep the balance of the Treasury's current account with the Bank of Italy near zero. A credit balance covered by outstanding Treasury bills means that the Treasury has to pay more interest charges.

Difficulties may arise in case the Treasury's cash needs require Treasury bill issues in excess of the banking system's capacity to absorb them. We are fully aware that this is a matter subject to our own influence: we can always, by injecting liquidity into the banking system, raise its capacity to absorb Treasury bills enough to take care of the proposed issue. But if ever Treasury bill issues could be placed only at the cost of liquidity creation beyond the economy's needs at stable prices, this would be the clearest possible indication of inflationary budget financing.

In case Treasury bill issues need to be in excess of the banking system's capacity of absorption at a given level of liquidity, and assuming that the monetary authorities have correctly determined that level and are, therefore, reluctant to raise it, the central bank has discretion to purchase, or not, the portion of the monthly quota which the market has not taken up. If the central bank does not purchase and part of the issue of Treasury bills, therefore, remains unallocated, the Treasury will be forced to draw on its current account and so to make it plain that its needs are financed by monetary means. This will not happen if, by co-operation between the Treasury and the central bank, the Treasury's needs are at once financed by the issue of government bonds.

But then the government competes with industry for investable funds and we have a problem in terms of real resources. We shall have to decide whether the government's budgetary cash needs are, or are not, compatible with the realization of all the other public and private investment programmes which draw their funds from the capital market.

Such a conflict between the financial requirements of the Treasury and those of production did, in fact, arise for the industrial credit institutes. The Treasury's indirect claims on the market through these special credit institutes – in the case, for instance, of the Green Plan for the improvement of agriculture – has the tendential effect of increasing the proportion of these institutes' loans to the Treasury in their total loans. Seeing that the amount of investable funds on the market is fairly rigid and that the share of them which the industrial credit institutes can hope to obtain by their bond issues is not greatly expandable, it would seem evident that if the Treasury attracts larger funds through the special credit institutes, production gets less.

On balance of the economy's foreign operations, the Bank of Italy and the Italian Exchange Office last year bought 308 billion lire's worth more foreign exchange than they sold. In 1961, the foreign sector's liquidity creation had stemmed almost exclusively from the balance-of-payment surplus, the Bank and the Exchange Office having financed a corresponding excess of foreign exchange purchases over sales; in 1962, by contrast, 269 of the 308 billion lire excess for which the Bank created liquidity went to finance foreign borrowing by the banking system. Having been authorized in October again to build up net debit positions abroad, Italian banks raised altogether 320 billion lire's worth of liquid resources abroad in the months of November and December.

This reopening of the connections between the domestic and foreign money market takes its place in a whole set of provisions which I have more than once had occasion to discuss. In the present context, I would merely point out that the creation of an Italian money market in which fixed quantities of Treasury bills are made available at variable prices was bound to produce, and indeed after some initial adjusting movements immediately after the reorganization did produce, a succession of inflows and outflows of foreign exchange. Banks began to administer their lire and foreign exchange cash holdings as one single unit. Whether at any moment they prefer Italian or foreign Treasury bills or other international money market securities depends, among other things, on comparative money rates in different markets.

Some doubts have been expressed as to the wisdom of our re-establishing the connection between the domestic and foreign market, in so far as this removes from our control one of the components of domestic liquidity. I would reply that the remedy may lie in the mechanism of variable interest rates which we have recently created. If need be, we could, of course, always separate the markets again, but we should be loath to do that, because I think we should learn to control domestic liquidity without having to interrupt the process of the integration of the Italian into the international economy. We might, however, regulate the conditions of foreign borrowing by the banks, just as we have regulated their reciprocal relations at home.

Thanks to the liquidity injections by the Bank of Italy and the Italian Exchange Office, the banking system was able to expand its domestic lending and security investment more than the year before and so contributed to a corresponding growth of the public's liquid resources. Last year's increment of loans to the domestic market, in the amount of 1,835 billion lire – compared with 1,391 billion in 1961 – came almost entirely from the banks; adding foreign lending and loans to the public sector, short-term credit expanded by a total of 2,014 billion lire. As against that, gross liquid assets rose by 2,712 billion; the surplus of gross liquid assets over credits to the domestic market grew by 877 billion lire, mostly by liquid asset formation corresponding to security investments, which channelled liquid funds towards the capital market and so made good the public's reluctance to take up the whole of the supply of security issues. The increment of the surplus of gross liquid assets over domestic credits, that is, of the public's net liquid assets, was rather unevenly distributed: large companies lost a lot of liquidity, medium and small companies gained. A new survey conducted by the Bank of Italy last year and covering 80 per cent of all liquid assets, reveals that the net liquid assets of large companies contracted by 440 billion lire and those of other companies and private individuals increased by 690 billion.

Anxious to improve our knowledge of monetary flows, we made a survey of 500 major agencies and companies with annual sales presumably in excess of 1,500 million lire, or, in the absence of information about sales, possessing plant of such value as might be considered to correspond to sales of that order of magnitude. Government-controlled agencies and companies were included regardless of the value of their sales. Now, the amount of external finance used by this group of companies was 779 billion lire in 1961 and 1,329 billion in 1962, of which 663 billion went to government-controlled and 666 billion to major private companies. The disparity between the two years' figures shows up the consequences of diminished self-financing capacity in the presence of rather large investment programmes. The branches in which net indebtedness increased most in 1962 were chemicals, mineral oils and electric power.

This conspicuous increase in the need for outside funds coincided with profound changes in their sources: in 1961 the banking system furnished 19 per cent of outside resources, in 1962 33 per cent.

The net bank debts of government-controlled agencies and companies rose from 524 billion lire in 1961 to 719 billion in 1962, those of the major private companies from 257 to 502 billion lire.

Classification of these figures by categories of economic activity enables us to make the following statements.

a) The reasons for last year's increase in the net bank debts of the major private companies were the difficulty of placing security issues on the market, the diminution of self-financing and the debt repayments of subsidiary electricity companies to their parent company. The sectors in which the phenomenon assumed far and away the largest proportions were electric power and chemicals; in the latter case, such security issues as were floated were not enough to finance plant construction in progress. Two-thirds of the increase in the net indebtedness of major private companies were concentrated in these two sectors. There can be no doubt that ENEL, the new government corporation which, in taking over the nationalized electricity companies has inherited their bank debts, must fund these as soon as market conditions allow.

b) Among government-controlled industry, the largest increase in bank credits occurred in the hydrocarbon sector, which was carrying out previously established investment programmes.

c) The exceptional increase in the indebtedness of both private and government-controlled companies was not fully matched by an increase in the value of fixed investment and working capital. The difference was used to finance export credits, only part of which could rely on industrial credit institutes; of 269 billion lire of export credits outstanding on December 31, 1962, special credit institutes had financed only 110 billion. The rest of the difference was employed by holding companies to purchase shares of their subsidiaries: the public's increased liquidity preference helped to expand bank credit to the large holding companies which, in their turn, transferred the proceeds through stock exchange transactions to minority shareholders desiring to sell.

Certain conclusions can also be drawn from an examination of the structure – and the last two years' changes in the structure – of industry's indebtedness to the banks, according to whether the companies concerned are large or medium- and small-sized and belong to the public or the private sector.

a) The ratio of net bank debts to the value of sales is higher in the case of government-controlled than of private companies. Although the latters' net indebtedness almost doubled in the course of last year, they still depend only marginally on bank credit, and some firms, for instance in the engineering sector, continued last year to maintain a net credit position vis-à-vis the banks.

b) The net bank debts of government-controlled agencies and companies have, in some cases, assumed such dimensions as to warrant closer scrutiny. In the mineral oil sector alone the relevant figure increased by 35 per cent last year. Adding to this the credits extended directly or indirectly by special credit institutes to finance exports against deferred payment, we cannot escape the conclusion that this huge indebtedness makes it necessary to co-ordinate this sector's investment programmes with those of other sectors.

c) Government-controlled agencies and companies borrow mostly from public-law credit institutes and banks of national interest, but last year by far the most conspicuous increase took place in credits from commercial banks and people's co-operative banks; in terms of net indebtedness, the year's increases were 113 and 64 per cent respectively.

All categories of banking firms which make up the banking system as a whole mistakenly tend to equate credits to government-controlled firms with credits to government itself from the point of view of risk evaluation, and banking firms with a private-enterprise structure seem to be more prone than others to this belief. The ease of access to bank credit seems to have played its part in inducing some government-controlled agencies and companies to rely on bank credit more than is right from the point of view of proper balance among various sources of finance, so much so that the problem has engaged the attention of the Joint Ministerial Committee for Credit.

Extending our examination to industrial credit institutes, we may say that the distribution of their outstanding loans seems satisfactory. Given that these institutes lend mostly to finance new plant, the distribution of their operations among the various sectors of the economic system is obviously a determinant of the latter's structure.

If the government wishes, as a matter of policy, to strengthen medium and small firms, it stands to reason that these categories must be given more credit; but that means giving less credit to other firms and to the public sector, and adapting interest subsidies to the sums that can effectively be made available to such firms, without raising expectations which might have to be disappointed.

Of all the credits extended by industrial credit institutes, the share of credit to medium and small enterprise was 29 per cent in 1960 and 35 per cent in 1962; correspondingly, the share of large private companies fell from 23 to 19 per cent and that of the public sector from 38 to 36 per cent. The average credit expansion in 1962 was 26 per cent, and credits to medium and small enterprise expanded by 33 per cent.

While industrial credit institutes raised their credit to medium and small enterprise relatively more, the growing pressure of demand led banks to do the opposite. Savings banks, finally, reduced their credits to public corporations to make room for an exceptional increase of 83 per cent in credits to major private companies. Since these credits are usually unsecured, they need, in most cases, an authorization by the Bank of Italy and, given the conditions of the capital market last year, such authorizations were not withheld.

In spite of the last two years' changes in the distribution of bank credits among various categories of borrowers, it still remains true that the great bulk of bank credits goes to sectors comprising innumerable small and very small firms. This is especially true of people's cooperative and commercial banks, although the latter, as we have seen, did not remain unresponsive to the appeal of government-controlled agencies and companies, to which they lent an extra 67 billion lire in 1961 and 121 billion in 1962. Nevertheless, the commercial banks' credits outstanding with small and medium firms, in the amount of 1,878 billion lire at the end of 1962, exceed those of any category of banks.

There is much talk at times ahout the influence the banking system has in fostering this or that kind of productive activity, as if the banking system handled merely the surplus of personal savings and not also the funds deposited by the self-same producers who make use of bank credit. A correct measurement of the effects of the banking system's activities can only be based on intersectoral monetary flows, and these, in turn, can be calculated only with reference to the changes in each sector's net debit and credit position. The trouble is that, while this sort of calculation can be carried out for big firms, it becomes rather difficult for medium and small firms, where the entrepreneur as head of the firm can hardly be distinguished from the entrepreneur as head of the family. In cases of this kind, debit and credit positions seem to alternate much more frequently.

Another difficulty is that these firms often borrow from, and lend to, each other, so that it is hard to identify with precision the ultimate destination of the funds that a bank makes available to any particular firm.

In collectivist economies all firms, of whatever form, are strictly forbidden to borrow from any other or lend to any other firm. All payments and all receipts go through the central bank, with which each firm has its own account, and wages may be paid out in bank notes. In these circumstances the central bank keeps account of, and can measure, all monetary flows from one sector to another, and on this basis checks whether the plan is being carried out according to its pre-established time schedule. Credit is regarded as the instrument by which money assets are redirected from sectors temporarily in surplus to others temporarily in deficit, but it plays no part whatever in determining the direction of investment, which is financed exclusively by public saving on the part of public administration.

Notwithstanding the profound differences between our economic order and that of collectivist countries, in both cases the moment at which the purpose of an investment is decided is when the funds specifically destined for it are made available. In our economy, that is the moment when a security issue is floated or when an industrial credit institute grants a loan. Exceptionally, at times when the banking system finds itself obliged to extend its operations into the field of competence of industrial credit institutes, the banks do have some influence, but only within the limits of such investment credits as they grant. The fundamental functions of the banking system always remain, on the one hand, to create a money supply and, on the other hand, to act as intermediaries in shifting liquidities from surplus to deficit sectors, for use as working capital. In the first of these functions the banking system is the channel through which the monetary authorities regulate the level of money supply in the economy.

Collaboration between firms and the authorities responsible for authorizing security issues, between these authorities and special credit institutes, and between the latter and the credit control authorities, is quite sufficiently developed to enable investment to be co-ordinated without impairing the entrepreneur's freedom of decision. Companies, and especially the larger companies, are used by now to furnish all the information necessary to discuss their long-term investment programmes and the authorization for any security issue is set within an overall finance plan approved by the credit control authorities on the basis of adequate knowledge about the various internal and external sources of finance. The credit control authorities try to balance the various sources of finance, but in 1962 it proved impossible to do so, given that the need was so great that we had to condone recourse to bank credit beyond the desirable limits.

Among the measures which influence investment, special mention must be made of privileged credits: credits, that is, which are eligible for interest subsidies on the basis of case-by-case decisions by government departments. By granting or not granting the subsidy, the government can exercise a selective influence on new investment. The importance of this can be measured by the fact that, of all credits the industrial credit institutes had outstanding at the end of last year, about one-third was privileged, and the proportion is even higher if we take only the new credits extended in 1962.

With more co-ordination in the government's regional industrialization policy we would most probably find we need to overhaul the present incentives system so as to fit all separate measures organically into one comprehensive system of unitary conception. Indeed, there might be a lot to be said for departing altogether from the present system which rests so largely on credit incentives. But whatever solution may be adopted, the decisions which determine the direction of industrial development in any particular area will always be incumbent upon government; given these decisions, it will be up to the banks to exercise their own judgement as to whether the companies requesting credits are capable of repaying them within the agreed time.

The credit control authorities' influence on investment has become somewhat more important through the regulation of the activities of industrial credit institutes and their co-ordination with the security issues floated directly by companies. The directives to be followed have been more closely defined in geographical and sectoral terms, but within these directives the institutes remain free to conduct their credit business according to their own judgement. Geographically speaking, the results would appear satisfactory. The distribution of new loans granted to industry by industrial credit institutes last year was as follows: 47 per cent to southern regions and the islands, 41 per cent to north-western regions, and the rest to north-eastern and central regions. Southern regions and the islands received 52 per cent more credit than the year before, and north-western regions 30 per cent more; in 1961 the corresponding increases had been 27 and 28 per cent. In other words, credits to southern industry expanded about twice as fast last year as in 1961.

In their turn, credits to the sector of public services expanded much faster in southern Italy and the islands than elsewhere in the country; the increase was 24 per cent as against a national average of 18 per cent.

As regards the distribution of the industrial credit institutes' loans by sectors of economic activity, the figures clearly reflect the intentions of the control authorities. We find a strong concentration in public services, and especially electric power, where companies had to carry on with work on plant already in construction, but could not raise funds directly on the market.

Large funds were channelled to telephone companies, which had to rely on credit, because failure to revise the tariff schedules narrowed their self-financing margins, and to shipping companies, for the shipbuilding programme concerning lines of national interest. Other sectors to which industrial credit institutes extended far more loans than before include engineering, iron and steel, chemicals, and, to a lesser but still considerable extent, textiles (where intensive modernization schemes are under way to offset the big increase in labour cost per unit of product) and the food processing industry, which is building new factories largely within the framework of the Mezzogiorno development plan.

The geographical distribution of mortgage loans on urban property extended by land and building credit institutes likewise shows some changes that are worth mentioning. The credit expansion in southern Italy and the islands was far in excess last year of that in central and northern Italy, and the peak points were Sardinia, Calabria, Apulia and the Abruzzi. As before, the strongest concentration of mortgage loans was in Latium and Lombardy, which accounted, respectively, for 26 and 28 per cent of all new mortgage loans last year; the reason for this marked concentration is, of course, the presence of the cities of Rome and Milan in those regions.

Although land credits extended last year were far in excess of those granted in 1961, there is a widespread belief that they diminished. This belief clearly stems from the fact that so many more credits are requested than granted. On December 31, 1962, the land credit institutes had credit applications for 347 billion lire under examination, had passed on applications for 240 billion with a favourable opinion, and had made conditional contracts for 264 billion. These figures make it quite clear that if all applications were to be granted, they would make heavy inroads into the claims of other productive activities.

It is, perhaps, not strictly speaking our business to analyse and express an opinion on the growing social cost of the lack of rational town-planning. But this social cost now begins to be reflected in the costs firms have to bear in the shape of higher wages, fewer working hours and lower working efficiency. I would consider it as my duty, therefore, to point out that the local inflation of property values, which is especially characteristic of large cities, is a matter that gives rise to some preoccupation, both because of its effect on the distribution of wealth and of its partly psychological repercussions on monetary equilibrium. However, in the absence of at least an outline of town-planning principles, the authorities responsible for credit control can hardly forestall by their own decision a future depending on choices yet to be made.

The industrial and land credit institutes' need for resources has increased beyond the capital market's supply, with the result that only 24 per cent of their bond issues were taken up by the public last year, as against 59 per cent in 1961. Banks and banking associations furnished the special credit institutes with 520 billion lire of new resources, which amount to 49 per cent of the total, and in the third quarter of last year alone the proportion was 56 per cent.

The Structure of Interest Rates

The monetary authorities have given much thought to the question of how to promote, within the limits of their powers, the creation of a structure of interest rates susceptible of generating a distribution of the public's liquid assets more in line with the use to which the investable funds are put. There is no need for me to recall here what measures we have taken; they have been discussed with many of you beforehand and you have loyally co-operated in their implementation. I shall limit myself, therefore, to explaining the motives behind these measures and the methods of their application.

In the determination of the structure of interest rates, considerations relating to the public's liquidity preference cannot be separated from those relating to the liquidity of the various investments financed by cash resources. This latter is subject to the influence of long-run factors, the foremost of which is the process of development in our economy which affects all sections of the market, including the capital market.

In the economically and financially most advanced countries, the evolution of the money and capital markets and the related growing importance of financial intermediaries have had the effect of making capital assets more liquid. The creation of a number of categories of securities, which as such are more readily negotiable than the real goods (buildings, plant, equipment, etc.) they represent, was accompanied by a continuous improvement of the negotiability of these securities, to the point of making money market paper interchangeable with the capital market's securities which are the counterpart of long-term investment.

The tendency of advanced societies to invest larger portions of capital in easily negotiable and increasingly liquid securities raises new problems for monetary policy. The boundary between liquid and non-liquid assets becomes blurred. The spectrum of liquidities is assuming more and more importance in response to the growing need to offer savers a wide choice, and conversely changes in the public's liquidity preference generate changes in the price of securities which, while easily negotiable, are not entirely liquid. Given that securities nowadays represent a growing share of national wealth, their price fluctuations may assume disturbing dimensions. It follows that we need an interest policy which helps to contain the amplitude of stock price fluctuations.

An analysis of the compound structure of short and long rates clarifies the tendency of the cross-currents between them by showing up, for instance, that short rates tend to vary more and are normally lower than long rates; but beyond that, such an analysis also points to the need to adjust the structure of rates of interest to the changing equilibrium conditions of the market.

In attempting to create a system of interest rates in line with specific purposes of monetary policy we had no intention whatever to perpetuate any particular level of rates, nor had we any preconceived ideas about their structure. On the contrary, we thought it right to proceed empirically and to learn from experience.

Our empirical methods can be summarized as follows:

a) The determination of short-term deposit rates, which fluctuate more sharply than long-term rates, is left to the judgement of the banks. With this attitude, the monetary authorities wish to make it clear that they do not consider themselves, at present, to be possessed of sufficient knowledge to replace the market by their own rules. They prefer to rely on the experience of the banks, in the conviction that immediate everyday contact with the market is a better guide than the views of any centralized administration. The monetary authorities do ascertain, however, whether the rates of interest fixed by the banks are in line with the purposes of monetary policy. To the extent that the bankers have agreed on any particular structure of interest rates which appears to us to answer the above purpose, we would ask them to respect it and, when they judge it to be overtaken by events, to propose its modification.

b) As regards medium- and long-term funds, the rates of interest, which are less subject to fluctuations, are determined by the direct intervention of the monetary authorities, especially in the case of bond issues. The rate of interest and all the other conditions which determine effective bond yields are agreed in each separate case with the Bank of Italy in the light, naturally, of the present and prospective conditions of the capital market and the money market.

c) The structure of interest rates which is the result of the rates established by the current interbank agreement and those established by the monetary authorities on the occasion of their authorization for a security issue seems, at the moment, to answer the need of promoting a distribution of the public's investable funds between bank deposits and security investment such as to give the monetary authorities adequate scope for liquidity control.

It depends, of course, on the conduct of the monetary authorities, and, in particular, on the liquidity creation of the Treasury and the Bank of Italy, whether and how much bank deposits can grow. The banks are obliged to maintain certain proportions between the public's deposits and their own tied deposits in compulsory reserve accounts, and for this reason the banks are not free to determine the volume of credit and thereby the amount of money supply which is its counterpart. However, when the banks raise their deposit rates, and consequently stimulate the public's preference for keeping a larger portion of funds in liquid form, they do generate an equidirectional short-term movement of bond yields, which means that bond prices fall. This may force the monetary authorities to intervene directly or indirectly to support bond prices, not least in order to make sure that the Treasury can raise finance at acceptable conditions. In this manner, the monetary authorities may be led to create liquidity beyond the limits they judge desirable. It follows that effective liquidity control cannot do without interventions designed to maintain a balanced structure of interest rates.

When I say a balanced structure of interest rates, I mean that it must answer two purposes: it must prevent short-term deposit rates from rising to such an extent that they pull up the long rates, and it must prevent them from falling below certain levels, which would simply divert part of the liquid resources from the banking system to other forms of investment less susceptible to control by the monetary authorities.

Compliance with the interest rates making up the structure approved by the monetary authorities in no way displaces the banks from their position as the link between the central bank and the capital market. Ever since government securities, not only of short but of long maturity, and securities of government corporations began to enter the banks' portfolios in far from negligible quantities, this connecting function has become established practice even in the countries which were the cradle of orthodox banking. But this function would cease to be discharged in the public interest if the banks, contrary to the rules which govern a given structure of interest rates, were to invade the territory of special credit institutes by attracting funds which, otherwise, would have gone to these institutes in the form of bond subscriptions.

If banks attract to themselves monetary assets which should have spread throughout the productive system through many other channels, and if they make it a habit to finance the formation of new fixed assets especially on the part of large firms, then we may have to introduce adequate controls. This view of ours has found expression in the provision by which the Joint Credit Committee gave power to the Bank of Italy to require specific banks, or groups of banks, to set aside special liquidity reserves whenever we should become aware of distortions in the distribution of the public's saving.

I need hardly mention, surely, that the normal functioning of the capital market depends on other conditions as well. In particular, the public will buy bonds only on condition that it believes the purchasing power of money will be maintained. In addition, government policy must be such as to offer reasonable assurance that no measures will be taken which would lead to sudden changes in the qualitative composition of the securities traded on the market, where a large increase in the supply of certain stocks might depress their prices.

A case in point is the manner in which the nationalization of the electricity industry was carried through in Italy. Great care was taken to minimize the effect on the stock market of a sudden qualitative change in so large a proportion of equities. The companies which owned the electricity firms were left in existence and they will be paid compensation in ten annual instalments, which can be discounted by special credit institutes in case some company wished to make productive investment sooner. This solution has not, of course, relieved the market of all the repercussions of so profound a change in the content of electricity shares, but the effects were much less serious than they would have been if the compensation had been paid at once in the form of bonds.

The modalities of the nationalization of the electricity industry have been widely and fully discussed. In the present context, I would merely state that they were inspired by the need not to allow the monetary authorities to lose control over the market. The payment of compensation in ten annual instalments makes it possible to raise the necessary funds on the market without seriously disturbing its equilibrium. Even if the companies entitled to compensation payments speed up the latters' conversion into liquid form by discounting them with special credit institutes, this would not prevent the monetary authorities from confining such operations within the limits compatible with market equilibrium; furthermore, ENEL's powers to issue bonds against subscription in electricity shares enable shareholders to convert equity into bonds without depriving the monetary authorities of their ability to regulate the supply of bonds.

As regards the possibility of index loans, I would point out that these have already been tried in some countries without success. Even apart from these unsatisfactory experiences, however, I would mention the following drawbacks:

a) An index expressed in terms of output, product prices, gross receipts, profit margins, and such like, can be applied only to bonds issued by companies which produce an identifiable good, but hardly to bonds issued to finance such public investment as cannot be covered by budget surpluses. Does anyone really believe in the viability of a financial policy resting on the co-existence of two categories of bonds in the same market? would this not simply mean increasing the cost of funds raised by non-index loans?

b) One of the consequences of such a system might be that an index is applied also to the bonds of government or quasi-government corporations whose activity is such that they cannot assume output and prices as parameters. The index could then be expressed only in terms of the general price level or other measures of the purchasing power of money. In that case the same solution would surely have to be extended also to government stock. Would this really widen the market, or would it not rather increase the cost of the enormous amounts which the government must raise somehow, directly or indirectly?

For the rest, it is our conviction that the public should be offered a greater variety of securities and that, if need be, we should create new types to meet the public's preferences. For this reason, we have revised our previous views about convertible bonds and have authorized a convertible loan stock to be issued by Finsider. This holding company had entered the market in support of its subsidiaries' equity, and by limiting the price fluctuations of steel shares had contributed to the stability of the market as a whole. By the convertible bond issue the company is now to obtain from the market the funds laid out in advance for the purchase of shares and for financing current investment programmes. The public will be offered a stock which throws a bridge from the present to the future, when investors may well prefer equities.

To sum up, the capital market is one integrated system; the more it is improved, the more interdependence will there be among its various sections. When the customary self-financing capacity of firms is curtailed for transitory or lasting reasons companies become more dependent upon the capital market, and unless the latter can supply what they need, they may have to borrow from the banks. But this cannot go on indefinitely without peril to the preservation of a credit base compatible with monetary stability.

The Problems of the Immediate Future

If I have dwelt so much upon short-term problems, it was because I believe that they are the ones which must above all engage the attention of the central bank. Some of them are urgent. Unless we at once adopt energetic measures to solve them, we shall be in no position even to think of long-term policies. The forces which combine to push up prices, the deficit in our balance of payments, the pressure on the capital market of convergent public and private demand for funds to finance domestic and foreign investment as well as exports against deferred payment – all these are urgent problems to which we must attend in the immediate future.

This Report explains the reasons which have generated a price rise often in excess of that in other major industrial countries. There are many reasons and we must guard against any partial interpretation of the phenomenon; the very variety of causes might confuse our view of the events of the recent past and prevent us from disentangling the causes and their interconnections so as to find those to which to attribute most weight. I regard it as my duty to repeat that the principal cause of the price rise was, and still is, the increase in wage levels in excess of the increase in average productivity in the economy as a whole.

The problem of the relationship between productivity, wages, costs and prices requires solutions concerned with the long, no less than with the short, period. National income cannot rise at a rate corresponding to the target of our economic policy, nor can it be distributed between investment and consumption in proportions such as to eliminate existing imbalances, unless we accept the fact that private consumption must grow less fast than real national income. This means we must create more capital, and especially more social overhead capital yielding no immediate returns.

I have said earlier that the cost increases have not been entirely passed on to prices, but that part of them were absorbed by profits. The problem now is to get going a process of readjustment between costs and prices on the basis of a new equilibrium which safeguards the international competitive strength of our economy. But it has to be underlined that the effect of wages rising faster than average productivity in the economy as a whole cannot be offset by price movements in the presence of a general mechanism of sliding wages. There are, in the productive process, latent forces which push up the price level. It is our duty not to add to them.

The redistribution of income last year was associated with a lower propensity to save. In 1961 national income at current prices rose by 10.5 per cent and gross capital formation by 15.3 per cent; in 1962 national income at current prices rose by 12.2 per cent and gross capital formation by only 10.3 per cent. In terms of constant prices the slow-down in the rate of increase in real saving was even more pronounced, given the relatively bigger price rise in 1962 compared with 1961.

Although the redistribution of income deprived firms of profits which might otherwise have been used for new investment, this does not necessarily imply a diminution of the total supply of saving. It may imply less voluntary saving and, therefore, a need to make good the deficiency by more public saving. If this should be held to be impossible, the policy of income redistribution must stop at the limits drawn by its effects on the provision of finance for investment. To transgress this limit means endangering the balance of payments. In 1962, an increase of 10.3 per cent in gross formation of saving was accompanied by an increase of 13.4 per cent in gross saving destined for domestic uses, the difference being furnished by drawing down the balance-of-payments surplus on current account.

Experience suggests that the relationship which exists in our economy between personal saving and self-financing by firms cannot easily be modified in the short run. This is confirmed by the time sequence of an initial rise in wage costs followed by a rise in retail prices. While the rise in retail prices tends to reabsorb the increased purchasing power of distributed incomes and so to limit their allocation to saving, the same price rise also tends to reconstitute the self-financing margins of firms.

If the monetary authorities restrict the money supply they impede this process of readjustment, and the deficiency of domestic saving is then balanced by a reduction of investment, which depresses the level of employment.

Having learnt from experience, the governments of all major industrial countries have now formally accepted the need for an incomes policy as the only way out of the intolerable dilemma between unemployment and inflation.

The reasons which impose an incomes policy also define its scope and field of application. Without necessarily aiming at a limitation of real consumption, incomes policy is generally so conceived as to regulate cost and price movements in such a manner that incomes grow in an orderly and socially acceptable fashion; it should leave room for such differentials as may be necessary in order to preserve to wages their function of determining the distribution of manpower, and in order not to petrify any given economic structure. It is also common ground that incomes policy must apply with substantially equal principles both to those incomes which are determined by bilateral negotiations and which account for the bulk of gross national product, and to those which are determined indirectly by market prices.

Incidentally, the interdependence between a certain distribution of incomes, a certain level of investment and the maintenance of incentives for rational production through the most efficient combination of factors of production is at present the subject of critical reappraisal also among the planners of collectivist economies.

If countries with such profoundly different economic orders feel a need to adjust the distribution of incomes to the requirements of economic growth, this may be taken as proof of overriding importance. Least of all may such an incomes policy be neglected in a country like ours, where voluntary saving is the mainstay of investment. Voluntary saving may be supplemented by a contractual saving, but even then the latter's amount cannot be determined coercively in our economic order. The link between the distribution of income and the amount of saving confirms the need for an incomes policy, which of course must be comprehensive, in so far as one could not imagine it to apply to some incomes and not to others.

The monetary authorities have the task of matching investment with disposable saving. To this end they have to set up and maintain a capital market through which saving is channelled to investment at the best conditions. The monetary authorities have the task of preventing investment from being financed by liquidity creation such as would cause aggregate demand to expand beyond potential supply, in cases when the excess of demand is more than can be met by reabsorbing the balance-of-payments surplus or by digging into reserves more deeply than is judged right to finance cyclical fluctuations without prejudice to the external stability of the currency.

If all the public and private investment programmes known to us were to be carried out, they would, in 1963, require special credit institutes, public agencies and private companies to issue bonds, net of repayments, and shares in an amount which we estimate to be well in excess of 2,000 billion lire. Special credit institutes would be responsible for the major part of these, given that they would be called upon to lend out something like 1,600 billion lire, most of which they would have to raise on bond issues. Of this total, 900 billion lire would represent loans on behalf of the Treasury or to meet credit demand stimulated by interest contributions by the Treasury.

Nor do these estimated 2,000 billion lire include direct Treasury issues, such as might well become necessary, especially if the cash deficit should grow. In any event, if expenditures which properly pertain to government are financed without revealing their entire amount when the budget estimates are submitted to Parliament, it is much harder to assess the effective needs of public finance.

The rate of increase in industrial investment was not matched, in 1962, by an equivalent rate of increase in self-financing, and this, as I have had occasion to repeat more than once, has forced companies to look for more outside finance; in so doing, they came up against a deficiency in the supply of saving. Larger portions of personal saving were kept away from the stock market to be used instead for the construction of dwellings, and the very composition of personal wealth changed to the detriment of the relative share previously invested in securities. Hence the growing demand for capital, including funds needed for public investment, failed to find an adequate supply on the market and the resulting strain was overcome only thanks to a whole set of interventions on the part of the monetary authorities.

The net proceeds of total security issues last year were 1,642 billion lire. The public took up only 857 billion, and the rest was subscribed by banks and banking associations as well as by agencies whose cash resources go to the Treasury – in other words, money supply was created to take up the securities. The banks were enabled to step in because the central bank raised their liquidity and thereby ultimately the liquidity of the public.

We could do this in 1962 because the resulting larger demand of the public, while not matched by an equivalent expansion of domestic supply, could be met by imports which reabsorbed our balance-of-payments surplus. In 1963 the situation is no longer the same. Our balance of payments is heavily in deficit, and we cannot afford to expand liquidity any further to make room for security issues. Inescapably, all the expenditures which have to be financed on the capital market, whether they are expenditures by government, local authorities, public corporations, other public bodies or private companies, will have to be subjected to a critical reappraisal and will have to be co-ordinated. If total requirements exceed disposable saving, less urgent expenditure will have to be postponed. The task will be eased if priorities are established according to a general plan.

Faced with last year's cost increases which, even though part of them were absorbed by profits, unavoidably also spread to prices, the central bank regarded it as its duty to inject sufficient liquidity into the system to finance production at rising prices, so as not to endanger the continuity of growth. We acted under no compulsion and accept full responsibility for what we did. But we would not be doing our duty as a central bank if we failed to give notice that, in the present conditions of our balance of payments, we cannot go on creating liquidity generating an excess of demand over domestic supply, in order to satisfy the flow of uncoordinated public and private investment demand which reaches the capital market in excess of the foreseeable supply of saving. If we did, we would risk an external deficit of such dimensions as to be incompatible with the maintenance of the currency reserves which, as a country so strongly dependent on international trade, we must have.

In that case, the situation which, while difficult enough, still is, and can be, kept under control, would cease to be controllable.

It is, finally, up to the central bank, the banking system and the other institutes which are part of our credit system to put at the disposal of government an efficient capital market, and a money market flexibly responding to changing business conditions and linked with the capital market. I should hardly need to repeat again that we cannot have an efficient market without a proper co-ordination of the inflow of short-term and long-term funds, and that such coordination is impossible in the absence of disciplined behaviour by all credit institutions, whether they are subject to public or to private law. Within the limits of autonomy conceded to each of the two categories of institutions and in compliance with the general rules applicable to all, the system has a sufficient degree of competition to stimulate progress.

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The year 1962 was not an easy one either for those who make monetary policy or for those who have to implement it. Both have had to overcome considerable difficulties. For our part, we were comforted by the conviction that we were doing our duty and by the certainty that we could rely on your loyal collaboration. I want to say once more that collaboration does not imply mere passive acceptance of our arrangements. On the contrary, we firmly believe in the merits of a discussion in which you freely express your opinions according to a long tradition which has proved its worth. We shall continue to accept your advice and to adapt our behaviour to changing needs, as they appear and are brought to our knowledge with your help. Such controls as it is our duty to exercise over your activities, we shall continue to administer with prudence, in fulfilment of our task to safeguard the nation's saving, as the law requires us to do.

It is surely a matter in which we may take satisfaction that informed discussions among employers and workers, academics and businessmen now take it for granted that there is more to the defence of monetary stability than the esoteric decisions of the central bank. It requires the deliberate collaboration of all social groups through their representative organs – trade unions, local government at municipal, provincial and regional level, and government itself. Let us not lose courage if occasionally the pattern of response to the day's events seems confused; it would be demanding the impossible at this stage to expect leadership from social forces not yet used to accept responsibilities of a general character. The process by which they rise to such responsibilities is not completed, nor can it be completed in a short while.

But while this process goes on, you and we have to live up to our own responsibilities, which are not light. For your part, you have to conduct yourselves impartially without giving way to outside pressures, and to exercise your independent judgement within the limits of the controls which surround your activities. Whether the organization of your firm falls into the sphere of public or of private law is irrelevant in this context: every one of them must vie with all the others so that all of them may become efficient instruments for advancing the common weal. As regards ourselves, it is our duty to safeguard the conditions in which you can act impartially. It is our duty also to defend our independence against the power of the state. This does not imply insubordination of any kind, but independence in the sense of being a dialectic counterweight in the machinery of government: the limits of the central bank's co-operation are marked by the point at which, in its conviction, the stability of our currency ceases to be safe.