Concluding Remarks for 1963

Gentlemen,

The expansion of Italy's economy last year and the strains it experienced made heavy demands on the Bank of Italy. We found we had to intensify and extend our activities in many fields, including rediscounts, operations on the foreign exchange and the capital market, and banking control.

General Economic Conditions

In April last year, the Council of Ministers of the European Economic Community addressed a set of recommendations to member states concerning ways and means to restore economic stability. In so doing, they pointed out that all member countries, save one, were suffering from mounting inflationary pressures and balance-of-payments disequilibria, which propagate the effects of inflation.

Not so very much earlier, at the end of 1962, the Community tendered the advice not to adopt any provisions which might subserve the deceleration of economic expansion and make the economy more sensitive to possible recessive tendencies, not least including those originating abroad. At that time, the conclusion was that cost increases not passed on to prices and therefore depressing profits might slow down the rate of investment, so that governments would have to come to the rescue of the economy with expansionary measures.

If I quote these two conflicting diagnoses one after another in such rapid succession, it is to underline the fact that the growth process of modern economies, and the underlying balance of factors, are subject to sudden major changes and may require equally sudden changes in the treatment by which we try to contain and counteract adverse developments.

Monetary policy is an important tool of the counter-cyclical armoury and, moreover, it can be applied fastest. It is hardly surprising, therefore, that when decisions begin to be taken in this field, some otherwise well-informed circles are not yet sufficiently aware of the changes which may in any particular case render these decisions necessary.

Consequently, the provisions of monetary and credit policy often receive an exaggerated interpretation quite out of proportion with their real significance and are the subject of, occasionally bitter, criticism, precisely because people do not as yet properly understand just why certain measures are proposed or adopted.

I mention this not because I want to complain of the unenviable duties incumbent upon a man who has the honour of presiding over a central bank; on the contrary, I want to say that I am well aware why the remarks I made here a year ago on the deterioration of our economic situation, on the need to take all possible countermeasures and not to rely solely on monetary policy, met with incredulity in certain circles or even with opposition, which waned only in the course of time.

I also knew perfectly well last year that our analysis of the economic situation in Italy was bound to be interpreted as transgressing into fields of competence altogether alien to its purposes. In point of fact, we were so anxious to draw attention to the immediate and more remote causes of the reversal of our economic fortunes that we covered a very wide field indeed – so much so that I felt I had to justify myself by saying that we must guard against any partial interpretation of phenomena which were obviously complex and interdependent.

Our analysis could not overlook the monetary implications of the rise of the wage level in excess of the increase in average productivity in the economy as a whole, which occurred in 1962; but our consideration of this aspect of the question was not, and could not properly be, disconnected from consideration of other, though less potent, contributing factors which were discussed on the same occasion.

In dwelling on the strains and stresses originating in old-standing and well known imbalances of the Italian economy, on those of foreign origin which in recent times have assumed particular importance in the system of economic integration to which we belong, on those due to changes in the capital market and, more especially, also on those called forth by the wage rise – in dwelling on all these strains and stresses, I repeat, the intention was to draw a full picture of the by no means easy conditions in which the monetary authorities had to make their choices.

We explained, it will be recalled, how in wide areas of our economy profits could not fully absorb cost increases without forcing firms to interrupt investment programmes they already had in hand; we also explained why, in the conviction that their interruption would lead to serious destruction of wealth, we accepted the need to help finance these investment programmes by means of liquidity injections, even though we knew this meant helping to finance also part of the cost increase and ultimately some price increase. We dwelt at some length on the changes which had occurred in the distribution of income and on the diminution of self-financing funds; this caused firms to make heavier claims on industrial credit institutes and the latter to float more bonds, some of which were taken up by the banks thanks to the increased liquidity we allowed them.

By now, the Report on Economic Conditions in Italy in 1963, with its documentation on the profound changes that have taken place in the growth of income, consumption and investment during the last two years and on the upheavals in our balance of payments, has confirmed the view we had founded essentially upon our interpretation of balance-of-payments developments during the last quarter of 1962 and the first quarter of 1963, when, in terms of seasonally adjusted figures, our current account was still in balance.

The years 1962 and 1963 were years of labour conflicts, sometimes upheld by prolonged strikes, which eventually raised wage incomes by 43 per cent on the average. Now, wage incomes account for almost two-thirds of our national income, and even if other money incomes had not changed, a rise of such an order of magnitude would have increased aggregate income in monetary terms appreciably more than real income. But mixed capital-and-labour incomes in trade and other tertiary activities also increased, and to prevent the rise in aggregate money income exceeding that in real income – a necessary condition of price stability – would have meant not only wiping out profits in large areas of our system of production, but also making it impossible for firms to set aside normal depreciation allowances.

In terms of economic theory, it might be argued that this would have signified no more than passing on to wage earners part of the profits previously accumulated. But it so happens that a large proportion of past profits had been invested in plant and could not, therefore, be distributed in the form of money. As I said, the monetary authorities created liquidity to the extent needed to prevent widespread and serious financial difficulties among firms. But the authorities were well aware of the dilemma they so created for themselves: to the extent that the additional purchasing power did not push up prices, it would increase the deficit in our balance of payments. An inviolable limit was set by our need to protect our reserves at an adequate level.

Even a country like the Netherlands, which was distinguished in recent years for its monetary stability, lately saw its wages rise ahead of average productivity in the economy as a whole, in the course of an adjustment of the wage level to that of neighbouring countries. Last September the Dutch authorities forecast a wage increase of 8 per cent in 1964 and a price increase of 2 per cent; a few months later, in January 1964, the prediction had to be revised upwards to 16 per cent for the wage rise, and the additional 8 per cent increase was expected to raise prices, in turn, by an additional 5 per cent. The burden of this larger increase, the authorities held, could not be shouldered by firms, since such a profit fall would have forced them out of business. More than half the wage increase would have to be passed on to prices in order to reconstitute profits. The original estimate of a 500 million guilder surplus in the Dutch balance of payments had to be revised and a deficit of 1 billion guilders is now expected.

Wage drift, or an excess of effective wages over contract scales, assumed large dimensions in some European countries during the last two years. In Italy, it was confined to the more congested areas and to a few categories of workers. The phenomenon cannot, incidentally, be measured by comparison between the indices of minimum contractual wages and of actual wages. It is true that in recent years the latter were well above the former, but this was due to the application of certain contractual clauses which had the effect of raising effective labour costs. We know for certain, from a mass of information on wage contracts and many representative firms, that the divergence is largely attributable to those components of labour cost which are ruled by agreement.

The initial impulse to the wage rise came both from the increase in contractual minimum wages and – sometimes more so – from changes in contractual conditions concerning such matters as grading, retraining, equal pay for female workers, reduction of working hours and, hence, more overtime at given personnel levels. Later, too, negotiated improvements continued to be the main factor in the progressive wage inflation. On top of that, employers in areas where the labour shortage began to be felt most keenly tried to attract the workers they needed by offering higher than contractual wages. The phenomenon gained ground with the increasing shortage of unskilled workers, who notoriously have more geographical and intersectoral mobility; eventually, matters got still worse as the pool of highly skilled labour approached exhaustion and not nearly enough money was provided for labour training.

Investment displayed a tendency to slow down in the course of 1962 and 1963; in real terms, gross investment rose by 19.2 per cent in 1960, by 11.3 per cent in 1961, by 8.2 per cent in 1962 and last year, when the real gross national product went up by 4.8 per cent, real gross investment rose by only 4.1 per cent. It follows that last year's credit expansion gave no additional impulse to investment or to an expansion of demand which would have derived therefrom, and hence did not pull up prices. The credit expansion was in most part absorbed by the final stages of plant construction begun in earlier years, when companies were confident that they could count on self-financing to a much greater extent.

Wage drift assumed large dimensions during the last two years in building, where activity was greatly stimulated by the inflow of savings withdrawn from the stock market. Reliable estimates suggest that private funds going into housing were about 600 billion lire in 1960 and 1,190 billion in 1963. This increase of 590 billion lire compares with something like 250 billion supplied to the building industry by the credit system during the same period, while new public housing funds decreased by 120 billion. Thus, the building industry received only 130 billion lire of new money from sources other than private saving. The clear implication is that higher family incomes and the saving public's disillusionment with tumbling security prices have reinforced the concentration of old and new private savings in the real estate market.

Wage incomes in the public and the private sector rose by almost 4,000 billion lire in 1962 and 1963. This new purchasing power burst upon the consumer goods market and spread like wildfire in all directions, making its strongest impact on food. Food expenditure went up by 28 per cent. Allowing for intervening price increases, food consumption in real terms rose by 5.4 per cent in 1962 and by 7.3 per cent last year. At the same time, the gross marketable product of agriculture increased by barely 1 per cent. The result was an expansion of food imports by 54 per cent, which it proved impossible to make good by the export of manufactures. Last year's additional food imports alone cost 340 billion lire; to pay for this with increased exports of manufactures would have meant an export expansion of 15 per cent on this score alone. It appears quite obvious that the redistribution of income during the last two years and the consequent shift of demand to sectors like food, where the elasticity of supply is small, were bound to affect the balance of payments.

The adverse effects on the balance of payments of increased demand for other consumer goods and for services are more difficult, if not impossible, to assess individually. In spite of industrial growth some strongly expanding industries last year were unable to satisfy the swollen domestic demand, and at the same time increased investment and, even more so, growing consumption pushed up imports. This applies more particularly to engineering products and among them especially to motor cars, to fuel and power, textile raw materials and many others of lesser individual importance. Nor did our own engineering and textile industries relax their efforts to export more, and the same is true of a few minor industries largely run by small entrepreneurs, who in the past did not often bother to visit foreign markets; the motor car industry, on the other hand, had to neglect its exports to meet high domestic demand. On balance, taking imports and exports of food products on the one hand, and non-food products on the other, the deterioration was about the same in both cases, namely, around 345 billion lire.

Two propositions which are often heard nowadays deserve critical re-examination. These propositions are:

(1) The income shifts of the last two years were bound to affect demand; it should have been foreseen that a growing proportion of demand would be directed towards qualitative improvement in some consumption sectors not adequately satisfied before, such as food; had our production system been efficient, it should have immediately supplied more of the products capable of meeting the new demand.

(2) The weakening of our competitive position as a result of the transfer of cost increases to prices could have been mitigated if we had at once proceeded to investments designed to raise the productivity of labour by increasing the capital endowment of individual workers.

The truth is that no production system in the world could have withstood without trouble the shock of a redistribution of income and consequent demand shifts on the scale of Italy's experience these last two years. If we look back to the time before the upswing began, we see that investment last year was double the 1958 figure in monetary terms and 75 per cent higher in real terms; apart from its investment drive, our industry has had to face, in 1962 and 1963, an increase of 27 per cent in average labour costs per unit of product, whereas prices rose by 7 per cent.

Besides, the adjustment of domestic production to changed consumer demand requires time, and there may well occur intervals when aggregate demand exceeds domestic supply, and this is precisely why it is useful to have a place in a wider international market, so that deficiencies in domestic supply can immediately be made good by larger imports.

This is what we need our reserves for, whatever cries of protest went up in our country at the time when we accumulated them. Here also is the function of international collaboration agreements, which help to buttress reserves; and here lies the strength of the reserve currencies, like the US dollar, backed as they are by an enormous production potential which can be transformed into goods whenever need be.

Like many others, the problem is one of degree: it is perfectly in order to supplement domestic supply by imports, but only to the extent that we can afford in the light of the size of our reserves, due allowance made for the time that domestic supply needs to expand in adequate measure.

All this is not said in a critical spirit. I do not wish to pass judgement on the merit of past policies in certain important sectors, for instance animal husbandry, nor to say whether, by altering these policies, we could expand output sufficiently to close the huge gap which has suddenly appeared between production and consumption. It may well be that, without prejudice to our efforts to step up production in that sector, the ultimate solution is to promote industrial exports, so that we can earn the foreign exchange with which to buy abroad a rather large portion of our food supply.

In any event, it is quite unrealistic to imagine that the productive system can in all circumstances adapt itself instantaneously to changes in the pattern of demand. There are elements of rigidity in any economic order – witness the Soviet Union's sudden shortage of grains and meat. That country, too, has had to shop abroad for conspicuous quantities of food, paying for them with unusually large gold sales.

For a number of reasons, factors of production cannot easily be shifted in practice. It should hardly need repeating, in these circumstances, that the effects are worst when the sectors which attract most demand are those which produce goods having a bearing on the cost-of-living index. When this happens, the mechanism of the sliding wage scale clearly reveals its misconceived function, for it raises purchasing power in monetary terms without any corresponding increase in the quantity of goods.

To some extent the deficit in our balance of payments reflects a shortfall in the domestic supply of agricultural products and certain manufactures; it also reflects, in the case of some manufactures, a failure of domestic products to compete successfully with imports. Our economy is essentially an open one; to say that some sectors could potentially produce more of the goods consumers want, but cannot, in practice, do so because consumers prefer foreign goods as being cheaper or otherwise more attractive, is simply another way of saying that in the market conditions such as they are domestic supply fails to satisfy demand.

The excess of money incomes over gross domestic product at factor cost, in terms of constant prices, was 1,661 billion lire last year; this sum corresponds to 7.7 per cent of GNP so calculated, and prices, in their turn, rose by 7.7 per cent last year. Gross domestic investment was 6,772 billion and gross national saving 6,374 billion; the difference of 398 billion has had to be made good by lending less and borrowing more abroad. In a closed economy, price rises due to excess demand would curtail the consumers' purchasing power and would lead to forced saving for the very reason that consumers could not buy foreign goods.

Some foreign observers have raised the question whether profit expectations had deteriorated to such an extent in our country that entrepreneurs had become reluctant to embark upon new ventures. The way our economic system is set up institutionally and the way it works, it certainly is ruled by the profit motive; even collective economies, incidentally, are known to be moving in the direction of acknowledging profit as an incentive to efficiency. But if we look at the enormous demand for new finance and then at the scarcity of investable funds, we surely cannot escape the conclusion that the limiting factor was, and is, insufficient saving. We were able to make good the savings gap by liquidity injections so long as the latter did not raise prices beyond the point where they would have compromised the maintenance of equality between the internal and the external purchasing power of our currency. Price increases beyond that point would ultimately have caused more unemployment of disposable factors of production and a bigger deficit in our balance of payments.

Italy's experiences in 1962 and 1963, as well as those of many other countries since the war, go to show that monetary policy, the prime function of which is to regulate the volume of aggregate demand, cannot, by itself, cope with the business cycle.

Especially when the domestic and external objectives of economic policy get into conflict, monetary policy must soon be bent to the requirements of the balance of payments and budgetary policy must take over at home, both to regulate aggregate demand and to bring about an income distribution such that the relative proportions of investment and consumption enable the economy to expand in a climate of stable prices.

These same experiences also demonstrate, without a shadow of doubt, that in a situation of nearly full employment economic policy cannot achieve its aims without a consistent incomes policy. Incomes policy has become a necessary tool to assist monetary and non-monetary action in preventing income from exceeding the limits compatible with monetary equilibrium.

Regardless of a country's social order, modern economies, with their productivity differentials between broad sectors of economic activity and even within industry, are too complex for the traditional instruments of preventing cost inflation and its repercussions on prices; success in so doing is often accompanied by a sharp deceleration of development, or even brings it to a complete halt. The evidence is clear: there is a choice only between accepting an incomes policy or else recurrent stoppages of development and a consequent fall in employment.

Meanwhile, the economic and social purposes of incomes policy, its means, scope, standards of application and the conditions of its success are gradually taking shape in the discourse between government experts, businessmen and trade union representatives in all the major Western countries and also in the general economic pronouncements of Soviet policy makers.

If trade unions accept an incomes policy, this does not in any way imply subordination to the decisions of others; on the contrary, by helping in the formulation of the economic plan which is to underlie government policy and by agreeing to an income distribution which serves the purposes of this plan, organized labour has an opportunity of playing its part in an orderly process of structural social changes to the effective benefit of the working classes. Lately, the governments of the greatest nations have placed before public opinion schemes inspired by different principles, but all proclaiming that the prosperity of the community as a whole depends upon the majority's resisting the temptation to raise the quantity of money they receive for their own work without, in return, raising the quantity of products in the same measure.

But government must do more than admonish. Modern governments are also employers on a large scale, and in this capacity it is up to them to demonstrate by their own behaviour in practice towards what kind of incomes policy they wish to guide the behaviour of the public. In Italy, the wage bill for persons in the employment of the government, local authorities and autonomous government agencies amounted to 3,184 billion lire in 1963. If we add the wage bill of major government-controlled companies and of social insurance institutes, we get a figure well in excess of 4 billion. This means that something like one-third of the country's total dependent labour incomes is directly or indirectly under the control of public authority.

Money Supply and the Banks

The liquidity which the monetary authorities create through their operations with the foreign sector and the domestic market reaches the public either directly in the form of bank notes or indirectly through credits conceded by the banking system. The funds which the banking system supplies to the economy through credits either return to the banks in the form of deposits, or, to the extent that they do not, remain in the hands of the public in the form of bank notes.

Whenever the amount of means of payment which the banks supply through credits is such that the borrowers exercise demand for more goods than domestic supply provides, the excess purchasing power injected into the economy either raises prices or turns abroad or, generally, both.

The monetary authorities do not have unlimited power over the volume of liquidity supplied to the economy and are only partly free to choose, at their discretion, the channels through which liquidity flows into and out of the economy. Within the limits of their discretionary power, the monetary authorities inject liquidity through one or the other channel in the light of the immediate effects they wish to produce.

Early in 1962, when we had a large balance-of-payments surplus to mop up, it seemed right to distribute liquidity widely over the whole banking system by reducing the compulsory reserve ratio; this served the additional end of making it possible to complete investment programmes already begun in the public and private sector alike.

At the beginning of 1963, one of the sources of liquidity creation was the redemption of the maturing issue of nine-year Treasury bonds. The liquid funds so created were channelled to the economy through the special credit institutes, which were enabled to place their own bond issues more easily with the owners of the redeemed government stock.

A similar effect was achieved by placing bonds with those agencies which keep their funds with the Treasury. Finally, the banks were authorized to make good such liquidity losses as the balance-of-payments deficit would have caused them by borrowing abroad; as a counterpart to their foreign debts, the banks made loans explicitly connected with the productive process, because foreign-currency credits may be granted only to facilitate imports, usually of raw materials, and exports of finished products.

An additional reason for giving the banks this faculty was that capital exports and their repercussions on our official reserves required some offsetting inflow. Thus capital exports were met by imports of short-term funds through the banking system. Net capital exports in 1963 amounted to 559 million dollars and were more than matched by an increase in the banks' foreign indebtedness of 650 million dollars.

The accumulation of foreign debts by the Italian banks was stopped early in the summer. It will be recalled that this development was foreshadowed in the Annual Report last year; we warned that we would introduce restrictions, if and when they became necessary to supplement other measures we were preparing in order to confine liquidity creation within the limits required to keep a proper balance between the increment of money supply and the increment of real income and so to prevent any further considerable rise in the price level.

The Italian banks' indebtedness vis-à-vis foreign banks reached its peak in August 1963; since then, it has fallen off continuously and, on 31 March 1964, amounted to 311 million dollars.

In addition, we took two other kind of measures:

a) we facilitated the transformation of short-term debts into medium-term debts, and likewise facilitated medium- and long-term borrowing on the part of companies, local authorities and public agencies, thereby initiating a process of partial funding of short-term debts. The total amount of medium- and long-term debts contracted between July 1963 and March 1964 by banks, local authorities, companies and public agencies together was 407 million dollars;

b) we conducted conversations with central banks abroad, and especially with the Federal Reserve, with a view to reinforcing the system of reciprocal credit agreements.

Speculative capital movements of conspicuous magnitude occurred in October 1963, but they assumed dramatic proportions in the first two weeks of March 1964, when the Italian Exchange Office intervened to the extent of 255 million dollars.

In the second week of last March, we held discussions with the monetary authorities of the United States, that is, the Treasury and the Federal Reserve. The outcome of these discussions is known: the conclusion of reciprocal credit agreements involving an amount of altogether 600 million dollars, with the participation of European central banks. These credit facilities were intended to help us defend our official reserves by acting as a shock absorber for the speculative attacks against the lira. We have so far used 150 million dollars of these credit facilities.

In addition, arrangements were made for medium-term credit facilities with the Export-Import Bank and the Commodity Credit

Corporation. Finally, loan negotiations were opened with the International Bank for Reconstruction and Development on behalf of the Cassa per il Mezzogiorno.

On that occasion we made a drawing of 225 million dollars on the International Monetary Fund. The size of the operation was tailored, on the one hand, to the Fund's need to reconstitute its lire resources, nearly all of which had been used up in lire operations by the Fund, and, on the other hand, to our gold subscription. This leaves completely intact our chances of borrowing from the Fund; we may wish to do so within the framework of a financial aid programme to be worked out in the first instance with the European Economic Community, in the spirit of structural harmonization and policy co-ordination which it is our common, and not easy, task to achieve.

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In 1962 net liquidity creation amounted to 801 billion lire, in 1963 to 861 billion. In 1962, 390 billion lire went directly to the public in the form of an increase in note circulation, in 1963 the figure was 441 billion. The rest went to the banks and enabled them to fill up their compulsory reserves to the extent required by the increase in bank deposits. The banks' payments into the compulsory reserve accounts amounted to 380 billion lire in 1962 and to 432 billion last year. On balance, the final effects of the liquidity injections was to augment bank liquidity by 31 billion in 1962 and to diminish it by 12 billion in 1963.

In 1962, the foreign component contributed 308 billion lire to total liquidity creation, in 1963 it absorbed 375 billion. The Treasury, on balance, created 12 billion lire of liquidity in 1962 and 777 billion in 1963.

The liquidity component consisting of Treasury operations with the Bank of Italy and commercial banks testifies to the exceptional pressure of the Treasury's cash deficit in 1963. In itself, this would not signify very much without the additional observation that, in actual fact, the deterioration in the Treasury's cash deficit seems attributable not only to budgetary revenue and expenditures, but to the Treasury's overall transactions, including those with the Central Post Office Savings Fund, where enormous quantities of bonds, especially those floated by ENEL, had to be placed.

In 1962 the Bank of Italy, the Italian Exchange Office and the banks between them furnished the economy with credits worth 2,779 billion lire, including security investment; in 1963 the figure was 3,314 billion. The money supply injected into the economy through credits last year raised monetary assets by 2,533 billion lire; the difference of 781 billion went abroad as a result of the deficit in our balance of payments. This deficit was financed to the extent of 375 billion by drawing down official reserves and to the extent of the remaining 406 billion by an increase in the net foreign indebtedness of the banks.

While bank advances grew more in 1963 than in the preceding year, the rate of increase dropped sharply during the latter six months. During the twelve months ending in July 1963 bank credits expanded by 25.8 per cent and during the twelve months ending in December 1963 by 21.1 per cent. In 1962, credits expanded by 15.1 per cent during the last two quarters, in 1963 by 11.4 per cent (the simultaneous increase in deposits was 12.5 and 9.1 per cent respectively).

In its turn, note circulation has been growing at a steadily decreasing rate since last June; during the twelve months ending in June 1963 it expanded by 21.0 per cent, during those ending last December by 14.3 per cent.

The slowing down in the growth of money supply since July 1963 began to make a major impact in the early months of this year. Between March 1962 and March 1963 net liquidity creation (969 billion lire) had taken care of the whole of the increase in the public's liquid assets in the form of bank notes (509 billion) as well as of 485 million for compulsory reserve payments by the banks, thus leaving the latter with a small liquidity loss of about 25 billion. During the twelve months ending in March of this year, by contrast, net liquidity creation (287 billion) was much less than would have been needed to finance the 321 billion increase in the public's bank note holdings and the 200 billion compulsory reserve payments by the banks; the shortfall of 234 billion was met by a contraction of bank liquidity.

To round off the picture, it needs to be added that, during the twelve months ending in March 1963, the foreign component contributed 323 billion lire to liquidity creation, whereas during the subsequent twelve months it absorbed 701 billion. It follows that the combined effect of the Treasury's and the Bank of Italy's operations was liquidity creation in the amount of 646 billion lire during the former twelve-month period, and in the amount of 988 billion, or 342 billion more, during the latter. Thus, the Treasury and the Bank of Italy not only made good the liquidity loss due to the balance-of-payments deficit, but added 287 billion.

Still in terms of twelve-month changes, bank advances expanded by 19.7 per cent up to January 1964, by 17.8 per cent up to February and by 16.0 per cent up to March 1964 (the corresponding increases in deposits were 11.6, 10.6 and 9.5 per cent respectively). The rate of increase in note circulation slowed down continuously, with the exception of March, when the Easter holidays during the last week of the month temporarily reversed the tendency. The twelve-month increase up to April 1963 was 18.7 per cent and 8.4 per cent up to April 1964; now, in May, the trend seems to continue.

Taking the combined expansion of current bank accounts and of the circulation of bank notes and other means of payment, total money supply increased by 19.9 per cent in the twelve months up to March 1963, by 17.9 per cent up to June 1963, by 16.9 per cent up to September 1963 and by 12.7 per cent up to December 1963. The deceleration has continued so far this year; in January the figure was 11.3 per cent, in February 9.8 per cent and in March 9.0 per cent.

In spite of a deceleration so gradual that foreign observers sometimes expressed doubts as to the effectiveness of our measures, the credit expansion nevertheless did go on. It is hard to understand, in these circumstances, how the monetary authorities can be accused of deflationary policies, as they have been accused by certain circles. Instead of looking at the actual dimensions of the phenomenon and of interpreting it with due regard to the country's overall requirements, these critics seem to draw substance from the inevitable hardships suffered by business. It is true that more credit is needed again because production costs have risen further and it is difficult to transfer the rise onto prices; hence companies have to rely more heavily on outside sources of finance.

But if we take a dispassionate view of last year's economic and monetary events and interpret them in the light of objective statistical figures, we see that over the course of the year bank advances expanded at a higher rate than did deposits, because part of the purchasing power created by the banks through credits did not return to the banks in the form of deposits, but instead went abroad in the form of an excess of import expenditure over export receipts.

Nor is this all. In spite of the failure of part of the purchasing power injected by the banking system into the economy to return to the banks in the form of deposits, current accounts increased at a higher rate than did real income; in other words, the increase in current accounts and monetary circulation, that is, the money supply, was considerably larger than the real income increase, and this was reflected in the rise of prices.

Surely, it is not open to doubt that in the presence of more credit expansion producers would have managed to transfer some of the increased cost pressure to prices, and a higher price level would have sucked in more goods from abroad, given that aggregate demand expands not least because of the existence of sliding wage scales. It is just not possible to go on using the mechanism of the sliding wage scale to safeguard the real value of wages and at the same time to want an easy credit policy, for such a policy would do nothing but lift prices still further.

The divergence between the rates of expansion of loans and of deposits was not the same in the various sections of the banking system. However, even in the case of banks with an above-average loan/deposit ratio, the ratio of loans to total liabilities was reassuringly in line with sound banking principles. Banks with a below-average loan/deposit ratio are generally those which keep part of their liquid resources on deposit with other banks, mostly big ones, or with their banking associations. When these smaller banks expand their own credit, they have to draw more on these resources deposited with the big banks, and as a result the latters' liquidity diminished and they present more bills to the central bank for rediscount.

Now, a large part of the banking system's cash pool is concentrated in the biggest banks, and these had to draw more heavily than before on sources other than deposits from the public. These other sources of funds are interbank deposits, foreign deposits, and recourse to the Bank of Italy; the latter amounted to 1,942 billion lire on 31 December 1963. The Bank of Italy had requested the banks to be rather sparing with foreign exchange credits financed by currencies held in deposit from foreign banks; clients, at the same time, tended to replace foreign exchange credits by lire credits. In these circumstances, some banks exercised more demand for deposits from other banks and borrowed more from the Bank of Italy. In the event, the big banks were responsible for 63 per cent, or 272 out of a total of 431 billion lire recourse to the Bank of Italy last year.

Interbank deposits, foreign deposits and transactions with the Bank of Italy carry different rates of interest; it follows that certain inequalities arise from the differential proportions of the funds drawn from these various sources by any particular bank. On the other hand, recourse to the Bank of Italy is administered by the latter mainly with reference to the liquidity situation of each separate bank, and the different measure in which banks can draw on this source of funds creates differences in their average borrowing costs. Furthermore, interest rates on interbank deposits being lower than those on foreign deposits, there is a tendency to scramble for these domestic funds and this puts obstacles in the way of our policy to keep the interest rate on interbank deposits in line with the Treasury bill rate. It would seem necessary, therefore, that monetary policy try to unify the terms on which domestic and foreign money market funds are exchanged, and to eliminate or at least reduce the causes which make for inequality of conditions as between separate banking firms.

Another obstacle to effective liquidity control is that public agencies, seemingly under some sort of peripatetic compulsion, keep moving large sums of money from Treasury accounts to the banks, *or vice versa*, or from one bank to another. When the movement in or out of Treasury accounts takes place with the Treasury's active participation, the close collaboration between the Treasury and the Bank of Italy does away with the danger of distortions in the process of liquidity creation. But this is not so when the owners of the funds act on their own initiative. When huge amounts are withdrawn from one bank and deposited with another at a time of generally tight bank liquidity, the central bank may be obliged to make good the liquidity loss of the bank from which the funds are withdrawn without being able to prevent the liquidity gain of the bank into which these monies are paid.

As conditions are at present, it seemed right to renew the interbank agreement without modifications which would have affected the current relationships between interest rates permissible for the various categories of accounts. In effect, the categories of accounts which attract monetary resources are unevenly distributed among the various sections of the banking system, so that any changes in relative rates of interest would alter the distribution of monetary resources not only among the various categories of accounts, but also among banks, and the results for the system's total recourse to the central bank would be much the same as those described above.

In 1962 the banking system's loans expanded by 1,995 billion lire, and its credits to large companies by 475 billion; in other words, new credit extended to large companies accounted for 24 per cent of total new credit. In 1963, the banking system lent out a net total of 2,268 billion lire, of which 369 billion, or 16 per cent, went to large companies. Its new credits to public agencies were 198 and 130 billion respectively, and those to medium-sized and small firms 1,322 billion in 1962 and 1,770 billion last year. This latter group of firms thus got 66 per cent of the total credit increment in 1962 and 78 per cent of it in 1963. These figures are eloquent testimony to the fact that a strong flow of new credit in 1963 was directed to the small and medium-sized companies, and not to the big ones – in line with suggestions the Bank of Italy has more than once addressed to the banks.

Special Credit Institutes, the Capital Market and the Use of Finance Funds

Like the banks, industrial credit institutes last year channelled a relatively larger share of their new loans to medium-sized and small firms. In 1962, these latter had received 286 billion lire out of a total of 673 billion new industrial loans granted; in 1963, they got 313 out of a total of 623 billion, and their share of new credits therefore passed from 42 to 50 per cent. By comparison, government-controlled companies borrowed 215 billion lire of new money from industrial credit institutes in 1962 and 132 billion in 1963, and other large companies received 90 and 77 million, respectively, in the two years.

Privileged credits to medium- and small-scale industry, under the terms of Law No. 623, amounted to 160 billion lire in 1962 and to 133 billion in 1963; those for Mezzogiorno industrialization, under the terms of Law No. 634, rose from 41 to 75 billion. These developments were in line with the policy intention of concentrating a larger proportion of privileged credits within the geographical area under the competence of the Cassa per il Mezzogiorno.

Together, new loans granted last year by industrial and by land and building credit institutes, including transactions on Treasury account, were 1,310 billion lire in 1962 and 1,178 billion last year. In 1962, the banks furnished 520 billion of the funds required for ordinary loans and 391 billion in 1963, corresponding, respectively, to 49 and 32 per cent of the total. The peak point in the banks' share in the supply of funds to these credit institutes occurred in the third quarter of 1962, when the figure was 56 per cent; in the following quarter it came down to 51 per cent and in the corresponding periods of 1963 it was 40 and 25 per cent respectively. This relative contraction was a response to a directive of ours of which we gave notice at this meeting last year, when we warned that it would not be possible to finance investment credits by liquidity creation instead of savings.

The containment of bond issues within the afore-mentioned limits has had the result that enormous loan commitments accumulated in industrial credit institutes. On 31 December 1963, these institutes had commitments amounting to 1,049 billion lire, of which 604 billion were promised to small and medium-sized firms, 264 billion to large private and government-controlled companies, and the rest to public agencies. At the same time, credit applications waiting for approval amounted to another 928 billion lire; 6,080 of these applications, involving an amount of 698 billion, came from small and medium-sized firms.

Net new security issues on the capital market dropped from 1,642 billion lire in 1962 to 1,340 last year; this was just a little more than in 1960 and 1961. The public, that is, investors other than the banks and those institutions which keep their funds with the Treasury, took up appreciably less than before, namely, 677 billion lire against more than 1,000 billion in 1960 and 1961, and 971 billion in 1962. Equity issues were 608 billion lire in 1962 and 267 billion last year.

These figures may be explained and interpreted as follows:

a) The stock exchange crisis of the second half of 1962 showed its full effects last year, when barely half as much new money was raised on equity issues than the year before. The reason was not that applications for equity issues were refused but that they were not presented or, in some cases, that the applicants themselves seemed in some doubt as to whether they could place their shares on the market.

b) Considerable parts of new bond issues were not sold to the public during the last two years, but placed instead with banks and with agencies which keep their funds with the Treasury; whereas this group of institutional investors took up 28 per cent of net new issues in 1960 and 30 per cent in 1961, they accounted for as much as 65 and 62 per cent, respectively, in 1962 and 1963. The Treasury's support to the market last year amounted to 536 billion lire, in the shape of bond subscriptions by the Central Post Office Savings Fund and redemption of Treasury bonds.

c) Even though less bond issues were authorized than were applied for and part of them was taken up by the banks, and notwithstanding the Treasury's support to the market, the index of stock exchange prices for the bonds of industrial credit institutes dropped from 117.8 in December 1962 to 107.3 in December 1963; yields correspondingly rose from 6.02 to 6.61 per cent.

The Bank's Annual Report in 1962 discussed at some length the problems connected with the size of the capital market in Italy, in comparison, also, with other countries. The conclusion was that the market could not conceivably go on expanding at the current pace. Last year on the same occasion we warned that no repetition of the events of 1962 must be expected, and drew attention to the danger that the changing quality composition of the securities traded on the market was bound to affect the latter's efficiency.

What happened subsequently confirmed that more bonds were being floated than could be placed without providing inflationary finance for them. Throughout the years 1956 to 1962, with the sole exception of 1959, more than 30 per cent of the new money raised by security issues came from equities; in 1963 the proportion was only 20 per cent.

It seems obvious, in these circumstances, that it would make it easier to finance investment without recourse to inflationary means if we succeeded in rearranging the composition of total security issues to suit investors' preference. We need to interest all the various categories of investors, including new institutional investors. To do so, two conditions are essential:

a) Economic policy must be such as to enable companies to be reasonably sure that they can cover their costs and still to leave open the possibility that changing business conditions would be reflected in profits, as the residual element. Notwithstanding the imperfections of our stock markets, fluctuations in share prices do, in the long run, provide a measure of profit expectations.

b) We should introduce a stabilizing element into the market, such as, for instance, investment or unit trusts. This could be done without waiting for the reform of company law, by means of fiscal provisions; the dividend income of investment trusts could be wholly or partly exempted from tax liability under Law No. 1745 of 29 December 1962 and any profit they made on sales of securities could be declared as income not subject to direct income tax.

If institutional investors, such as insurance companies and social insurance funds, are to be given the faculty of investing in shares, and if we are to have investment or unit trusts, both the enabling legislation and relevant government regulations will have to insist on the investments being split up in adequate manner – majority share holdings must be ruled out – and on full information being furnished to subscribers so that they can exercise proper control. If investment or unit trusts are authorized also to include foreign shares in their portfolio, they will be able to offer the public a composite stock with an additional built-in price stabilizer.

But, however successful we may hope to be in bringing the equity market to the fore again as a source of finance, bond issues still remain large. The reason is the growth of public investment programmes financed by bond issues, and also the further extension of the government-controlled sector in consequence of the nationalization of the electricity industry. As of 31 March 1964, no less than 1,120 billion lire needed to be raised by bond issues to finance the 1964 investment programmes pursuant to existing legislation and planned by ENEL, ENI and IRI.

Special credit institutes will have to make additional claims on the bond issue market, and, adding also short-term credit, we get a total of 1,640 billion lire. Lastly, industrial credit institutes will need some funds to satisfy at least part of private investment demand, and so will land credit institutes. All this together is far more than the market can absorb.

In these circumstances, the government cannot escape the necessity of setting up a scale of priorities in line with its economic programme, and of establishing a timetable of investment such as not to compromise monetary equilibrium. It is a matter of satisfaction to be able to note that the government has, in fact, begun a critical review of investment projects in various sectors, with a view to appropriate co-ordination. Once the government has taken the decisions which give the economy its policy directives, the central bank will play its part by spacing out authorizations for security issues in such a manner as to reduce the amplitude of stock price fluctuations very quickly.

But the central bank cannot make good deficiencies in the formation of saving by creating new money beyond the limit compatible with price stability and a return to balance-of-payments equilibrium. Nor can it force bond issues upon the banks, thus obliging them to restrict credits to firms. It is worth recalling, in this context, that the ratio of the banks' fixed-interest-bearing security holdings to deposits is no less than 15.6 per cent.

Within its powers of overall liquidity control, the central bank can do something to channel newly created liquidity this way or that, according to the immediate effects desired. We have, for instance, purchased government stock from public agencies so as to enable them to invest the proceeds in mortgage bonds; we did this in special consideration of the importance of mortgages for housing construction in some of our large towns.

All in all the capital market last year furnished the economy with 1,608 billion lire, either directly through security issues or indirectly through special credit institutes; in 1962 it had supplied 1,950 billion. Of last year's total, 22 per cent went into building (19 per cent in 1962) and 6 per cent into public works (5 per cent in 1962). The bulk of the rest was concentrated in manufacturing industries, among which steel, engineering and chemicals alone got 29 per cent of the total in both years.

The steel industry's share was rather bigger than before, because large sums were needed for the completion of the new steel mills under construction. The concomitant nature of bank credit was evident in its complementary pattern of distribution: the share of housing credit diminished from 14 to 11 per cent, that of credits to manufacturing industries increased and, more particularly, the proportion of credits to the steel, engineering and chemical industries rose from 25 to 28 per cent. Petroleum companies, which had 7 per cent of bank credits in 1962, had only 0.5 per cent last year, as a result of a public credit to them in the form of tax deferment amounting to 122 billion lire; in 1962, on the other hand, the banks lent the petroleum sector a total of 129 billion.

When companies can effect less internal saving because prices do not rise as much as costs, partly because of foreign competition, they naturally have to look for more outside funds on the capital and the money market. This generates the sort of imbalance between demand and supply which we call a credit squeeze. There is ample statistical evidence to the effect that in Italy during the last two years and in 1964 so far the reason for the credit squeeze has been not that the supply of bank credit fell off in absolute terms or expanded at only the same rate as the country's real income, but that demand raced ahead of supply.

Given the price rise and the growing deficit in the balance of payments, it became obvious that there was no point in injecting more liquidity into the market than we had to do in order to avoid serious stoppages of production. In these circumstances, many a voice was raised in favour of introducing a policy of more selective bank credits.

With this I do not, of course, mean the opinions of any particular companies which wanted more help from the capital market or the banking system; naturally enough, each one of them feels that its own needs should take priority over all others. I have in mind, rather, a view which is widespread especially among academic economists, to the effect that the credit squeeze could be greatly eased by more stringently selective credit control.

At present, selective control over the medium- and long-term loans of special credit institutes is exercised by the monetary authorities on the occasion of their authorization of bond issues by the institutes; similarly, all other security issues are subject to administrative authorization and, at that moment, to selective credit control. There remains, therefore, the question up to what point to strengthen the system by extending it to short-term bank credit. This is an extremely important question, on which we might usefully dwell for a moment at this point.

Throughout the 1950s, the expansion of bank credit corresponded to about one-sixth of the volume of simultaneous gross investment; since 1960 the proportion has been one-third. But bank credits to some extent also finance the public sector and household consumption; in part, furthermore, they are the counterpart of deposits by companies themselves. The net contribution of the banking system as one of the channels through which company investment is financed is, therefore, a good deal less than the figures of bank advances suggest.

Another important point is that, when it comes to making the financial decisions which are so weighty a factor in guiding investment activity, one lira borrowed from the banks counts less than one lira drawn from self-financing funds or from the capital market. The reason is that profit expectations are scrutinized much more carefully by the investing firms and by the special credit institutes when they decide to finance new plant with funds which, in an orderly market, must be partly the firm's own and partly raised through long-term borrowing. This is the sound financial basis of investment decisions; once it exists or arrangements have been made for it, short-term bank credit may be drawn upon for supplementary or concomitant funds or to prefinance investment.

The question of a qualitative control of bank credit for purposes of investment guidance can, therefore, rationally arise – and then only within the limited scope of bank credit – only after the authorities have already exercised their influence on long-term loans and yet the distribution of investment is still unsatisfactory.

It should be recalled, in this connection, that about one-quarter of the country's total gross investment is either made by public agencies in their capacity as investors or decided by them in their capacity as providers of finance; this figure, incidentally, excludes agencies which are themselves producers, and excludes also government-controlled companies and private investment in response to government incentives.

It should also be recalled that during the last four years private fund-raising on the capital market, either directly or through special credit institutes, has financed about one-quarter of all investment and one-third of private investment; in either case, it is subject to the approval of the monetary authorities, who in turn give or withhold approval in accordance with the directives issued by the Joint Ministerial Committee on Credit.

When we say that a considerable part of investment decisions is taken by public authorities and that another considerable part is governed by directives emanating from a committee of ministers in exercise of its legal powers, we remain strictly in the field of facts concerning the working of government in its legislative order, with results that are statistically measurable.

But in investment guidance, allowance must also be made for the effects of the government's influence on self-financing, and this is something we cannot measure. All we can say is that, in a mixed economy like ours, this influence must work indirectly, through framing the conditions of competition, through fiscal means, and – I repeat my hope – through an incomes policy. I would not presume to suggest at what rate of profit and at what distribution of profits such subtle government intervention should aim. All I want to do is to explain the setting in which banks have to take their credit decisions and to help fashion this setting in such a way that the banks are not asked to apply contradictory operational standards.

With this limited purpose in view, then, I would say that one of the intermediate objectives of a modern state's economic policy is to create throughout the whole productive system a degree of competition which is judged optimal from the point of view of reconciling social justice with income growth. Another is to modify the conditions of competition through fiscal means, that is, through taxes, exemptions and subsidies, whenever special localized purpose so require; these may include the protection of certain social patterns, incentives to entrepreneurship in certain regions, or capital formation among certain classes. A third of these intermediate objectives is to regulate the volume of aggregate money demand and of its major components through an incomes policy. If we successfully arrange the affairs of the nation so as to achieve these intermediate objectives, we shall have to accept the consequences – or else we shall be creating internal conflicts within the system of government intervention. In other words, we shall have to accept the structure of demand such as it is fashioned by these fundamental acts of government; then it will not happen that the ultimate objectives of government policy are frustrated if the apparatus of production is left free to adapt itself to this demand, and if the mechanism of bank credit is left to accompany and condition this adaptation process according to normal banking principles – that is, risk appraisal in terms of the firm's profit expectations and in terms of the real and personal guarantees the client can offer.

Even if it were possible to introduce more selectivity into bank credit, it is hard to see how to avoid arbitrariness, given the complexity and variety of the sector of medium-sized and small enterprise which relies upon bank credit and given, above all, the great number of medium-sized and small banks operating in geographically restricted areas. If the latter were asked to implement directives implying choices of high-priority sectors, they would be all but paralysed in practice, or else they would be forced into a concentration of risks incompatible with efficient safeguards for the class of depositors to whom they cater.

For all these reasons I believe that, in the conduct of modern government, qualitative control of bank credit is a tool to be kept in reserve and to be applied with moderation in special conditions rather than as a regular component of credit policy. In certain cyclical phases, one kind of credit may indeed have to be curbed in favour of others and, in exercising its overall powers of control and direction, the central bank has from time to time done so and may do so again. But we only have to look at the most recent developments to see that cyclical situations can change very quickly, and for this reason we must be watchful and flexible in anything we do to direct the flows of credit. Moreover, intervention of this kind is apt to have so many general and specific effects of opposite sign and unmeasurable magnitude, that it would seem safer for the monetary authorities not to assume direct responsibility for the innumerable adjustments required by cyclical developments, but to leave these adjustments to the market processes, within the general conditions created by control of the volume of liquidity.

Some Problems of the Moment

Recent experience in the monetary relations between Italy and the United States has proved that swap agreements and the US Treasury's issues of debt certificates denominated in foreign currency are realistic procedures capable of fruitful development. This may prove a flexible way of meeting any possible increase in the world's liquidity and credit needs. The credits being quickly reversible in case of a sudden change in the flow of funds or the respective balance-of-payments position, as the events of last March abundantly demonstrated, these reciprocal agreements effectively serve the interests of both parties concerned and not only those of one of them. They would, therefore, seem to have more merit than some of the abstract formulae suggested in recent times and might suitably become a permanent feature of the international monetary system.

These experiences, as well as the studies conducted by the so-called Group of Ten, have strengthened my conviction that, subject to possible minor adjustments, this system is sufficiently solid and flexible to meet the foreseeable needs of the next few years. However logically coherent other innnovations may apear, they would be acceptable only on condition that they are allowed to prove their worth in a long, and free, transition period.

We are in the fullest possible agreement with the efforts to speed up the process of co-ordinating budgetary and monetary policies with a view to the swift correction, or indeed prevention, of imbalances in international payments.

The progressive intensification of collaboration within the Organization for Economic Co-operation and Development and the recent decision of the Council of Ministers of the European Economic Community are steps in the right direction, in so far as they tend to make major decisions of internal and external monetary policy subject to systematic consultations.

Last April, the Council of Ministers of the EEC made a series of recommendations concerning measures to achieve, or consolidate, price and cost stability in member states, and made it clear that this objective was to take priority over all others at the present stage of the business cycle. For Italy, the particular recommendations were that tax increases should be distributed so as to slow down the expansion of private consumption while interfering as little as possible with company investment; that a full anti-inflationary programme should be worked out to complement the measures already put in hand to stabilize domestic prices and costs quickly and to improve both the country's competitive position and its balance of payments; and that, more generally speaking, the expansion of domestic demand should be held back by fiscal means, the policy of containing the credit expansion should be continued and a balanced incomes policy should be introduced, so as to keep the growth of nominal and real income in line as far as possible.

With the full concurrence of the Italian authorities and in a spirit of constructive collaboration, the EEC Commission is at present also investigating our economic position, under the terms of Article 108 of the Treaty. Discussions so far suggest that the afore-mentioned recommendations will be formulated in more precise terms and that others may be added in the light of such changes as may take place in our situation; these additional recommendations may concern commercial policy, public finance, credit policy and, finally, the ways and means of introducing an incomes policy.

Not only the EEC, but also other international organizations to which Italy belongs, are watching with attention our efforts to get our economy back onto an even keel. The success of the set of measures we have adopted in line with, and sometimes in anticipation of, the afore-mentioned recommendations has become a matter of common interest. It is a fact that the evolution of international economic relations limits each country's independence in formulating and implementing its economic policy, but it also diminishes the margin of possible error. Much more than in the past we shall, therefore, have to stand up in the international forum for what we do not do, and have to listen to constructive criticism and give account of any delay in the adoption of corrective measures for such domestic or external imbalances as may arise. It is right that this should be so, because, in a regime of fixed exchange rates and open economic frontiers, such imbalances tend to propagate themselves quickly to other economies, which can do little to defend themselves.

Real magnitudes and monetary magnitudes must be brought back into a proper relationship, which alone can remove the strains from which our economic system now suffers and put it once more on the road of balanced growth. This is a problem which can be solved only by the combined efforts of government, entrepreneurs and trade unions. It is also a problem which has many facets, of which I have discussed only those pertaining to the creation of monetary means in relation to income growth. This limitation corresponds to the boundaries of our sphere of responsibility and is not meant to imply that the other aspects are of lesser importance. To countercheck the conclusions to which our analysis has led us, we conducted a survey of the experience of a large number of countries in matters concerning the comparative movements of wages, production, liquidity and prices.

The survey covered the countries of the Common Market, the Scandinavian countries, Austria, the United States, the United Kingdom, Canada, Japan and Argentina. For each of these countries we calculated two ratios of indices, selecting ratios the time path of which is particularly helpful in interpreting the comparative movements of the factors under consideration. The first ratio was that between the wage index and the index of production, and its variations may be taken as indicators of variations in labour cost per unit of product in the course of the cyclical phases. The second ratio was that between the index of primary liquidities and the wage index;

changes in this ratio, together with those in the first-mentioned, indicate whether or not liquidity variations are connected with cost variations.

To put it briefly, the results of our survey show that economic expansion at more or less stable prices coincided with periods when labour costs per unit of product were stable or declining – with periods, that is, when monetary and credit policy was free to regulate the economic system from the sole point of view of an expansion of production and trade, without having to worry about cost inflation. In a phase of rising labour costs per unit of product, on the other hand, the rate of expansion of output was occasionally, and for some time, kept up by an increase in the system's liquidity allowing prices to rise, but in the longer run it always proved inevitable to apply a more restrictive monetary policy, and balance was ultimately restored only at the cost of slowing down the expansion of output for some time.

In Italy, where unit labour cost rose considerably in 1962 and 1963, the increase in the economy's liquidity did not fully reconstitute the liquidity of firms through a price rise, because of the simultaneous deficit in the balance of payments. We were not able to avoid a deceleration of development.

In the light of these facts, we must conclude that it would have been wrong, and would still be wrong, to try and re-establish the balanced conditions in which firms can increase production by means of a credit expansion beyond its current dimension; the result would simply be that prices would rise even further, and once domestic prices rise above foreign ones, the ultimate effect would be a larger deficit in the balance of payments and less employment. In these circumstances, the only acceptable policy is one designed to stabilize labour costs per unit of product. This can be done by prolonging collective agreements due to expire in the near future and by reducing the sensitivity of the sliding wage scale possibly, among other things, through a lengthening of the intervals between one adjustment and the next.

In the absence of measures to re-establish those internal relationships in the economy which are a condition of continued expansion, we had, and still have, to rely principally on the containment of the process of liquidity increase, so as to keep the expansion of monetary demand within the limits corresponding to the formation of real domestic resources. This we did, although we were not unaware of the dangers inherent in this mechanism of adjustment; the very containment of monetary demand may impair the formation of real resources.

These dangers are all the more serious, the more rigid is the cost structure and the narrower are profit margins. Any incipient downward move of prices would then at once come up against a solid barrier of costs, at which point a number of firms would either have to restrict production or to go out of business; the subsequent adaptation to the desired level of monetary demand would have to take place via employment, or, in other words, via an undesired reduction in real income flows.

The conclusions to be drawn from all this for the problems of the moment in the Italian economy seem contradictory at first sight.

There is much to suggest that the cost barrier is both rigid and near-by. The redistribution of income to the benefit of wage earners during the last few years has narrowed down the profit margins of firms, wage levels are fixed by collective agreements and the area of possible deviations from minimum contractual wages has become smaller than it used to be. Firms have higher expenses for social security payments, some taxes are assessed on the volume of production, and the operational conditions of public utility companies are such that tariffs cannot be reduced.

On the other hand, there is also something to suggest that our cost structure has by no means negligible elements of flexibility. In the areas of greatest industrial congestion and in cyclically sensitive branches of production effective wages have tended to rise above contractual wages, as we pointed out before. The overheated boom has made room, especially in building, for many small suppliers and service firms, whose mixed capital-and-labour incomes respond readily enough to demand conditions. The same applies to a considerable part of the incomes in trade, transport and agriculture.

Another element of flexibility is the extent of Italy's relations with the world economy and more especially the European economy, as evident in the large volume of exchange of goods and services and in the mobility of factors of production, especially labour. In a situation of full employment and high prosperity, such as several of our closest partners now enjoy, there should be more opportunity than there ever was in the past to sell our goods and services abroad instead of at home.

Weighing the elements of rigidity against those of flexibility, we are nevertheless forced to conclude that adaptation to a lower absolute level of monetary demand would curtail employment appreciably. But this is not really our problem just now in Italy; our problem is the more limited one of temporarily slowing down the rate of increase in demand. We do not need to bring prices down to the cost barrier or beyond; all that is required is that we do not allow labour costs and income transfers at the expense of the productive system to push costs up towards and beyond present prices. If we manage to avoid this cost push, we shall be able to maintain our economy's competitive position abroad without serious detriment to domestic employment.

We have tried, this year, to quantify the loss of competitiveness our economy suffered in the last two years; as can be seen earlier in this Report under the heading Balance of Payments, it seems that, while we have not wiped out all the advantages we slowly gained in ten years, we are more or less back at the position we held in 1958. In the meantime, however, income has grown more in Italy than elsewhere, and the ratio between the rate of increase in imports and the rate of income growth has gradually risen, especially during the last two years when imports expanded unusually fast.

But income per head is still not as high in Italy as in other countries, and we need to continue expanding income faster than they. To do so, we must not only eliminate the above-mentioned anomalous pressure on our balance-of-payments deficit, but also, more fundamentally, gain a bigger place in world trade. This is not to imply that we must regain the competitive position we had in recent years, when our balance of payments showed large surpluses. It will be enough, in the immediate future, to reduce our current deficit to proportions where we can finance it by ordinary capital movements.

Money supply, defined as the sum of note circulation and current accounts, would seem to be under control at present. During the first quarter of this year it increased at an annual rate of 4.4 per cent. Assuming that in 1964 gross national product in real terms will grow a little less than in 1963, and allowing for a certain margin of uncertainty in the index due to seasonal adjustment, this figure suggests that the formation of money supply has been reduced to a rate where it is compatible with reasonable price stability. We achieved this reduction by containing the expansion of bank credits, which, during the first three months of this year, increased at an annual rate of 6.4 per cent.

After a rise of 5.5 per cent in 1963, the general index of wholesale prices went up by 0.3 per cent during the first quarter of this year. Agricultural prices actually came down, and other prices went on rising only at the slower rate of the last months of 1963.

In the balance of payments, the current account closed with a deficit of 657 million dollars last year, whereas in 1962 it had still been in surplus to the extent of 276 million dollars. Seasonally adjusted quarterly figures deteriorated steadily from a record surplus of 225 million dollars at the end of 1961, down to a record deficit of 275 million dollars in the third quarter of 1963. No further deterioration, however, has occurred since, and indeed the seasonally adjusted current deficit showed some signs of improvement during the first quarter of 1964, when exports of goods and services increased and imports were stationary.

In April 1964, export proceeds fell short of import expenditure by 221 million dollars, as against 138 million in April 1963, but there was an offsetting surplus on other current items, and capital movements, too, were in equilibrium. In May, finally, provisional figures suggest equilibrium in the overall balance of payments; more particularly, the repatriation of bank notes seems to be only about one-tenth of what it was in May last year.

I regard it as my duty to state plainly that it would be a mistake entailing irreparable consequences to interpret these latest developments as signs of a reversal of fortunes in our economy. In any event, our monthly figures of external payments are far too heavily influenced by seasonal and random fluctuations to have more than very limited significance. The correct conclusions to be drawn from these apparent improvements is that we must persist with our policies, even though they are bound to involve sacrifices. It is just because experience shows our difficulties not to be uncontrollable, that we should be seriously failing in our responsibilities to the country if we proved ourselves incapable of keeping these difficulties under control.

Other countries, which have already gone through the transformations now taking place in Italy, encountered the same sort of difficulties. In our country, today, entrepreneurs and workers alike are pushing forward on the road to progress; both will surely find a way to combine their efforts, in the free discussion proper to a system of political democracy, so that the civic advancement of our country can proceed without interruption.

* * *

When meeting with you last year, I said that if we had a balance-of-payments surplus, we could pursue a credit policy designed to encourage a vigorous process of capital formation and the creation of many new jobs, but that we could not afford such a policy with an external deficit such as we had at the time. A large part of the additional purchasing power would simply have gone abroad instead of sustaining the liquidity position of producers, and by delaying the moment of decision we would have made the effects harder for the economy.

In discharging our responsibilities in this new and difficult situation, we draw comfort from our conviction that the social and political forces of our nation are becoming fully aware of the problems involved and realize that, while they are grave, they are also controllable.

In the gradual unfolding of actual events, we shall try to match total liquidity creation to the need of keeping prices stable and equilibrating our balance of payments within the period of grace allowed to us by our reserves and by help from abroad. Within the limits of our statutory powers, we shall also try to match our credit control to overriding countercyclical requirements, for it is these that ultimately govern the accomplishment of the fundamental objectives of economic policy, as formulated by the competent branches of government with the intent of sustaining the growth of both income and employment.