Concluding Remarks for 1965

Gentlemen,

Every year at this time it falls to the Governor to report to you on economic developments in our country; but the economy does not keep to the timetable of our annual meetings, nor can we analyse its underlying trend by looking at one year only. This is why, as I did last year, I again ask your indulgence in following me not only through the events of 1965, but also through others which have their context in a longer period.

To be realistic, moreover, we must range further also in space – not indeed, as may have been the purpose sometimes in the past, in order to make comparisons between national economic developments which were in large part independent of each other, but for the compelling reason that in the field in which our direct interests lie, national markets are gradually coming to be parts of one single, diversified but common, international system.

Within national economies themselves, we observe increasingly close interrelations between the activities of banks and other financial intermediaries, and between the markets for short- and for long-term funds.

Domestic operations and foreign ones, the capital market and the money market are not separate and cannot be analysed separately. They are interwoven into one single fabric, the pattern of which I shall attempt to describe to you. In order not to transgress the time at my disposal, I shall have to pass over even fundamental aspects of income and price formation; but these are discussed in due detail in the Report on the Economic Situation in Italy and in the separate analytical chapters of our own Annual Report.

Capital Markets and the International Monetary System

The first set of problems on which I wish to dwell concerns the international economic situation. Foremost among those which claim our attention at present are the problems of the supply of long-term capital in the countries of Western Europe, including our own, and those of the functioning of the international monetary system.

In recent years, the long-term capital requirements of both the public and the private sector have been racing ahead of the public's willingness to take up bonds at current interest rates. This disparate pace of increase places the monetary authorities in a dilemma: should they encourage the public to buy more bonds by allowing yields to rise, or should they keep down interest rates by letting the banks subscribe more bonds? The second alternative would, of course, involve acquiescing in an expansion of the supply of money and of those short-term credit instruments which go by the name of quasi-money. The dilemma is aggravated by the sheer size which the public sector has assumed in the economies of Western Europe, for its demand for capital is rather rigid and therefore makes total demand for finance funds less sensitive to changes in the rate of interest and places on the private sector virtually the whole burden of adjustment between demand and supply via changes in the rate of interest.

The width of fluctuations in interest rates can be reduced by channelling to the international market some part of the excess supply and demand which accumulate on national markets. With the latter intercommunicating again, any rise of interest rates in one country attracts funds from abroad.

In these circumstances, part of Western Europe's needs for long-term capital is satisfied by bond subscriptions through the banking system and by the inflow of foreign long-term capital. While both the public and the private sector, and in particular companies, look to the capital market in order to cover their requirements of outside finance by long-term borrowing, the household sector does not, at current rates of interest, exercise a corresponding demand for long-term securities; people prefer to accumulate their wealth in liquid form. These divergent preferences are reconciled through the intermediary of banks, both on the domestic and on the international market. Domestically, the banks acquire securities which represent long-term claims on companies as a counterpart to short-term de-

posits by households; internationally, they take into their own assets short-term claims on abroad, in the form of foreign exchange sold by companies which have incurred long-term debts abroad. If the central bank purchases the securities, bank liquidity increases and with it the banks' ability to grant additional credits; this amounts to creating money capable of generating further money. A similar expansionary effect on bank liquidity follows when capital imports from abroad give rise to a balance-of-payments surplus financed by the central bank.

These considerations apply particularly to the years since the establishment of the European Economic Community and the introduction of currency convertibility, that is, to the years since 1958. Throughout that period, long-term capital requirements in Europe have tended to rise more than income, for a number of reasons. First, economic development is associated with an increase in the capital/labour ratio; secondly, some of the new investment either does not directly produce income at all, or produces it only after some time; and lastly, companies have become more dependent upon outside finance and in the public sector budget deficits have tended to grow. There has, in consequence, been an upward pressure on rates of interest.

Since monetary policy has kept interest rates relatively low in the United States, the higher European rates attracted American capital. It might be said that, by exporting long-term capital and importing short-term funds in the form of dollar deposits from foreign central banks in American banks, the United States helped to meet demand for means of payment in one part of the world, to the extent that this demand was not satisfied by autonomous action on the part of central banks.

However, the circumstance that between 1958 and 1965 Western Europe accumulated balance-of-payments surpluses roughly matching the deficits which piled up in the United States during the same period as a result of long-term capital exports to Europe, does not justify the conclusion that we must look across the Atlantic for the source of the expansionary forces at work within each country's money supply. It would have been perfectly feasible for the central banks to offset the liquidity creation due to the inflow of American capital if their possible countermeasures had not come up against the inherent resistances of a developing economy – and it was precisely because Europe's economies were developing that they needed more means of payment.

The second half of the period under consideration was a time of unprecedented expansion in the United States. Wages on the average did not rise more than output per employed worker; labour costs remained relatively stable; the price level underwent no major changes; plentiful profits lessened the dependence of firms on outside finance and induced investment which led to the introduction of new techniques. The growth of social insurance and pension schemes based on accumulated funds increased institutional saving and the resulting regular flow of resources to the capital market so raised the efficiency of the New York stock exchange that it became the most important centre for the supply of long-term funds.

In most European countries in the meantime, and more especially during the last few years, the conditions of income growth were very different. Wages increased faster than productivity, costs faster than prices; narrowing profit margins helped to widen the gap between long-term capital demand and supply and to expand the money supply.

Recently, the voluntary restrictions on capital exports from the United States led the European subsidiaries of American concerns to finance large portions of their investment by funds raised directly on the European market. In consequence, the European issues of American companies increased greatly – in the first quarter of 1966 they amounted to no less than 220 million dollars – and bond yields have been rising more sharply. These latter are in fact now so high that some projected issues have been called off, which of course meant postponing the investment which their proceeds were to finance. It may happen, therefore, that the volume of productive investment by American-sponsored firms may fall; but the possible substitution of new plant put up by European enterprise instead would in no way alter the terms of the problem of finance.

What we need, in these circumstances, is to discover by what policies the European capital market can be enlarged, so as to ease the strain which capital exports put on the US balance of payments. This is the way for European producers to keep acquiring the most advanced technology without too many of them falling under the domination of transatlantic concerns.

But in the present conditions of supply of long-term funds, the European economy as a whole still has the choice only between restricting investment or else accepting a level of investment which may generate the creation of liquid financial assets possibly in excess of what is compatible with price stability.

In any decisions regarding such liquidity creation, the main voice belongs to the nation concerned, for it is inadmissible that the formation of liquid assets within any country should be governed by the liquidity policy of the reserve-currency countries.

It will be recalled that a series of meetings is being held at present among the Group of Ten, with a view to working out a basic agreement on improvements to be introduced in the international monetary system, including the creation of new reserve assets if and when this should prove necessary, so that there should be enough means of payment to meet the needs of the world economy. Later, negotiations will probably proceed in a wider group, so as to safeguard the interests of countries which do not belong to the Group of Ten. I want to make it clear in this connection that the Italian authorities have repeatedly stated their opinion on these problems, especially on the occasion of the annual meeting of the International Monetary Fund last September. The numerous reform proposals which have been under discussion so far take liberal account of our point of view as regards both principles and methods. So far as methods are concerned, I would mention in particular that it is now accepted that the creation of new reserve assets should take place in close association with the International Monetary Fund, that control over their creation should be the joint responsibility of the group of countries to which it will fall to furnish the underlying real resources, that the new assets should be distributed not in proportion to gold holdings but according to less arbitrary criteria, and finally that the new assets should be so used as not to weaken monetary discipline in member countries.

The current discussions rest on two premises. The first is that in the general view, at least of industrial countries, there is at present no shortage of international liquidity; the second, that the entry into force of any agreement must remain subject to the elimination of persisting balance-of-payments deficits in the reserve-currency countries and to an improvement in the mechanism of prevention and adjustment of external imbalances. These latter two points are stressed most strongly by the European countries; the French authorities, for their part, have come to the conclusion that, in the absence of these two preconditions, it is premature to try working toward any agreement.

We do not share this view. We believe that some agreement on the creation of new reserve assets, flanked by a reinforcement of

multilateral surveillance and by informal arrangements concerning a common reserve policy, is an indispensable condition of stability in the international monetary system, and for this reason we believe it to be in the best interests of the major industrial countries to exert themselves to reach agreement. Otherwise the international monetary system might, by default, take a turn toward schemes where the problems of new liquidity creation fuse into those of aid to developing countries, and this would set up barely controllable inflationary pressures in the world economy, ultimately without benefit even to those countries which push in that direction. Or else we might end up with a split among the principal industrial countries responsible for the good functioning of the system, with the result that the dollar would cease to be accepted as a reserve currency and that exchange rates would be set free to float. That would certainly spell the end of the process of integration of European capital markets, which are now tending to unify.

The Composition of Italy's Financial Assets and the Demand for Finance Funds

Now let me turn to the problem of financing development by non-inflationary means in our own country. In what terms does this problem pose itself in Italy? Drawing on past figures and on projections, let us examine the demand and supply position for the economy's financial assets – including shares, bonds, government stock, post office savings, bank deposits and bank notes.

For the purposes of this examination, let me take up again and develop the argument where I left it last year on the same occasion, when I pointed out that the Italian medium-term development plan made use of a system of national financial accounts divided by broad investment sectors: public administration including autonomous government agencies, government-controlled enterprises, building, agriculture, and a fifth sector of other activities including private industry and trade. With the help of this system of accounts, an attempt is made to measure the net indebtedness of sectors which invest more than they themselves save, as well as the corresponding formation of new financial assets in the household sector; the idea is

that this asset formation in the household sector must be co-ordinated with real income growth in a proportion which enables equilibrium to be maintained in the balance of payments.

According to the development plan, the process of development during the five years 1966-70 is likely to occasion in the five broad investment sectors a demand for finance funds, to be met by households, of the order of 18,000 billion lire; this would correspond roughly to 3,600 billion a year in lire of 1964 purchasing power. It would be up to economic policy to see to it that the demand for finance funds keeps within these limits, which are regarded as compatible with the household sector's propensity to hold part of its wealth in the form of an equivalent amount of securities, bank deposits and bank notes. In its turn, monetary policy would have to create the conditions for a composition of financial assets such that it suits those to whom they are to be supplied; one of the instruments by which this may be brought about is variations in the rates of interest.

Now, the changes which have taken place in recent years in the country's financial assets make it clear just how serious a task it is to call forth a flow of savings of such volume and in such forms as can satisfy demand of the order of magnitude mentioned.

At the end of 1958, the financial assets in the hands of the various sectors of the economy (excluding public administration and financial enterprises) amounted to 21,200 billion lire; by the end of 1964, the figure was 42,000 billion, which means an annual average increase of about 3,500 billion lire. The earliest separate figures we have on financial assets in the hands of households are for 1964; in that year, they show a net increase of less than 2,000 billion lire.

So much for the accumulation of financial assets. As regards their composition, two important structural changes have taken place in these six years, namely, an increase in the proportion of the more liquid assets and, among the less liquid ones, a shift toward fixed-interest securities; both these changes combined to reduce the proportion of shares. Alongside, there was a shift in the ownership of fixed-interest securities toward the banking system.

The economy's liquid financial assets amounted to 11,400 billion lire at the end of 1958 and to 24,600 billion six years later. They consist almost entirely of money and quasi-money; short-term securities account for no more than a negligible amount. The proportion of money and quasi-money in the total of financial assets rose

from 54 to 59 per cent between 1958 and 1964, and their proportion in gross national product from 58 to 70 per cent.

The second structural change is the shift toward fixed interest, as evidenced in the following figures, which neglect variations in equity prices. At the end of 1958, the economy's total security holdings amounted to 8,179 billion lire, including 2,482 billion of fixed-interest securities; by the end of 1964, the former figure had risen to 11,709 billion, and the latter to 5,122 billion lire. Hence the proportion of fixed-interest securities in total security holdings increased from 30 to 44 per cent.

The same trends continued in 1965. The proportion of money and quasi-money in the economy's total financial assets has risen to 60 per cent, and the proportion of fixed-interest in total securities to 47 per cent.

I pointed out, with reference to Western Europe as a whole, that part of the instruments of long-term debt are taken up by the banking system, which means that they have their counterpart in the banking system's short-term liabilities to the holders of bank notes and deposits. Italy is one of the countries in which this practice has assumed the largest proportions.

The long-term indebtedness of public and private enterprises and public administration together rose by 10,506 billion lire during the six years 1959-1964. Of these, 7,354 billion were taken up by individuals and companies and by the mathematical reserves of insurance companies; the remaining 3,152 billion found a place in bank portfolios.

Part of this expansion corresponded to real income growth and to a decrease in the velocity of circulation of money; to the extent that it failed to do so, it had an inflationary effect, that is, it was absorbed by a rise in the general price level.

In the course of the six years under consideration, the annual flow of long-term borrowing gradually increased from 855 billion lire in 1958 to 2,256 billion in 1964, and, in terms of gross national product, from 4.7 to 6.8 per cent. During the same period, the share of the total annual flow taken up by the banking system increased from 244 to 949 billion lire. In spite of the large volume of new issues, therefore, securities came to account for a steadily diminishing proportion of the total financial assets in the hands of final investors (individuals and companies); the figures were 39 per cent in 1958 and 28 per cent in 1964, and, counting equity holdings only, 27 and 16 per cent respectively.

In this case, too, the six-year trend continued in 1965. New long-term debts incurred during the year amounted to 2,963 billion lire, of which 1,671 billion were financed by long-term funds raised on the capital market and the remaining 1,292 billion by liquid asset formation.

To obtain the economy's total financial asset formation during the year, we must add to the above capital-market supplies such liquid assets as form the counterpart of long- and short-term credits from domestic and foreign sources and of credits to public administration; this total works out at 5,409 billion lire for 1965. Of these, the part of households, net of their liabilities, came to some 3,000 billion lire in terms of 1964 purchasing power; the increment of about 1,000 billion over the preceding year was made up half by bonds and half by savings deposits. The strong increase in bond subscriptions by individuals no doubt had something to do with reviving confidence in fixed-interest securities, but it also bears witness to the efforts which the banks have been making to sell bonds to the public. Nevertheless, it still proved necessary for the banks to take sizeable amounts into their own portfolios, given the galloping pace at which bond issues increased last year.

What I have said is confirmed by the pattern of ownership in fixed-interest securities. The total amount of fixed-interest securities outstanding at home was 4,217 billion lire at the end of 1958, of which, as I mentioned, the economy owned 2,482 billion, and the remaining 1,735 billion in bank portfolios accounted for 41 per cent of the total. The end-year total was 10,687 billion in 1964 and 12,800 billion in 1965; in these two years the bank held, respectively, 5,613 and 6,870 billion lire, or 52 and 53 per cent of the total.

In commenting upon the part which the banking system has come to play in our capital market, it has to be said that whenever the supply of investable funds falls short of the financing requirements of large-scale investment programmes in hand, the authorities are faced with the decision whether to accept the destruction of wealth which would follow from an interruption of these programmes, or else to finance them by the creation of new money. Now, the volume of investment under programmes involving the lapse of several years before production can start has been increasing in the public and in the private sector alike, and at the same time the current deficits of public administration have tended to grow. As a result, the monetary authorities have been losing much of their freedom of action in

controlling the total volume of credit; investment planning and the co-ordination of investment with public expenditure now have an essential part to play in any policy designed to adapt the money supply to real income growth in conditions of external balance.

Security issues in 1965 amounted to 3,185 billion lire, as against 2,767 billion in 1964; in net terms, last year's issues of 2,347 billion were 342 billion in excess of 1964. Net new issues of fixed-interest securities came to 1,971 billion lire, of which 66.9 per cent were bonds floated by or on behalf of the Treasury, by ENEL, ENI and IRI, including the Autostrade company; bonds by special credit institutes accounted for another 32.8 per cent. Given that a sizeable part of the proceeds of these latter bonds likewise served to finance government-induced investment, it follows that the decisions of the public sector governed the use of the great bulk of capital supply in the form of bonds. Individual investors, who had subscribed about two-thirds of the total in 1961, took up less in the following years until their share dropped to one-third in 1964; in 1965 it rose again to two-fifths. The rest was taken in by the banking system and social insurance funds; more particularly, banks and banking associations, which in the thirty months between January 1962 and June 1964 had subscribed 32 per cent of new issues, raised their share to 55 per cent during the eighteen months between July 1964 and December 1965.

The increasing say of government in channelling savings toward investment has been accompanied on a large scale by government grants and guarantees for purposes judged to be in the public interest. But privilege rates of capital cost and free government grants blunt the edge of the entrepreneurs' efforts at finding solutions which limit the use of capital to the strictly necessary. The socialist economies have realized this drawback and they are gradually abandoning the system of free capital supplies to firms and introducing instead credits on which firms have to pay instalments of principal and interest. It may be added that, if so much of investment is financed by borrowing that in effect the entrepreneur no longer contributes any of his own funds, this destroys the element of risk which is the distinguishing feature of private enterprise.

Centralized decisions from above with respect to interest-equalizing grants have a bearing also on the business conduct of credit institutes, in so far as they lend the proceeds of their bond issues to firms which are expected to meet their obligations under a contractual repayments schedule. Now, while the decisions of the

authorities responsible for grants do not necessarily imply any judgment on the credit-worthiness of firms, they certainly weaken the moral responsibility of the lenders.

The chief purpose of our system of incentives is to guide economic processes in the direction of progress, by encouraging industrial enterprises to settle in new locations and by promoting such changes in the existing apparatus of production as appear conducive to higher productivity and social betterment. But the trouble is that these transformations initially entail human costs and hurt vested interests. Under this sort of pressure, privilege credits and other government facilities of like intent as often as not bolster firms and arrangements which are threatened by technological change, or by changing tastes and other market factors, or by mismanagement; they are thus deliberately made to serve limited purposes of protection and conservation to the detriment of broader aims. These considerations suggest that the system of special facilities needs to be re-examined and probably pruned here and there, and then to be applied more strictly to sound, long-term purposes.

The closest attention should be given to the problem of tax reform in relation to the credit function as a whole. There is a strong case for reducing those taxes which lack the flexibility so necessary to the efficient functioning of the money and capital market, and which cannot be distributed rationally, so that – falling, as they do, upon financial intermediaries – they ultimately raise the cost of credit for producers.

If company finances are to regain a soundly balanced pattern in which there is room for more venture capital, no time must be lost in going ahead with the proposed reform of company law, coupled with the introduction of unit trusts, or investment funds, according to the government bill recently discussed by the National Economic and Labour Council.

The Banking System and the Capital Market

An enlargement of the capital market implies a decline in the relative weight of money and quasi-money in the composition of financial assets. The negotiability of the securities which compete with

money improves and indeed government stock becomes almost as negotiable as money itself, except, of course, that nothing can do away with the higher costs of trading securities in comparison with money, which can be spent directly.

But we have seen that in the particular case of Italy the proportion of money and quasi-money has increased to the detriment of securities in the years since 1958. This development went parallel with the increase in the banks' security investments, which I have mentioned and which has been assuming a large scale in the last few years when the banks, liquid as they were, have been seeking to attract additional deposits by offering higher interest rates while competitive lending reduced the price paid for bank credit. With liquidity remaining high, the banks have been using more of their resources to buy securities, and in addition large sums went into extinguishing the banks' foreign indebtedness and, in some cases, establishing a credit position abroad.

At the same time, labour costs per bank employee increased, the number of bank staff did not diminish and general expenses went up quite considerably.

There are some who begin to wonder whether bank managers are trying to combine lending and borrowing operations, and their respective conditions, in such a way as to arrive at a satisfactory profit level, or whether their behaviour is governed by the desire to conquer a larger share of the market for prestige reasons. No judgment can be passed on this question without a closer examination of the structure of banking costs and its flexibility in response to changing market conditions.

The costs directly attributable to the total supply of funds can be determined with a reasonable degree of approximation by deducting from total costs those connected with intermediation services, such as the purchase, sale and custody of securities, assuming these costs to equal commissions earned on these same services. So calculated, the cost of the supply of total funds for the banking system as a whole worked out at around 6 per cent in 1964. Administrative expenses, among which personnel costs loom large, account for about half, and the other half represents outgoing interest, including income tax category A; the former are highest in the smallest size class of banks, and lowest in the largest size class.

A bank's total administrative expenses vary less than proportionately with the amount of funds it administers. Therefore, additional

deposits and additional loans may improve operating results even in the presence of a narrowing margin between lending and borrowing rates.

This conclusion holds for the immediate economic results in a situation of keen competition and for each separate bank; it changes in the absence of these two limitations. At a later stage, the economic result may well be negative for a bank which tries to augment its share in the system's total deposits, if the higher rates paid for new deposits come to be applied also to earlier ones. For the banking system as a whole, the tide may turn even sooner, if the overall amount of new deposits attracted is small, in other words, if the higher rates offered on deposits fail to call forth an adequate increase in the public's liquidity preference.

It may be said, I think, that competition is widely held to be in the general interest, in so far as it keeps down the unit margins of intermediaries and promotes an expansion of the volume of business. But it must be added that in the particular case of banks the rigidity of administrative expenses, and especially of personnel costs, imposes upon management certain limitations which do not entirely belong to the competitive scheme of things, and which may lead the decisions of bank managers in the direction of pushing competition further than is good for the general interest. We can look to other countries right now for examples of such excesses of competition. Some banks are luring away from others not only existing deposits but even those that do not exist as yet, by arranging with large clients that they should pay in, on call, certain pre-arranged sums against interest rates of a dizzy height unknown in our market.

The merits or demerits of such policies on the part of banks must be seen also in the light of their asset structure, that is, of the nature of the credits and investments which are the counterpart of old and new deposits. It is the banks' asset structure which ultimately in large part determines the freedom of action of monetary policy in different cyclical conditions.

If we assume that in an economy the level and distribution of incomes as well as the structure of production are given, the requirements for working capital credits are also given. The banks' intermediation can expand, therefore, only into the foreign field or into the long-term field. The latter offers the larger scope.

The foreign assets and liabilities of our banks have been growing rapidly. It is unlikely that the related profits are large, but they still

are additional profits. At present, their foreign position, whether it be measured in terms of total foreign-exchange assets or liabilities, places Italian banks in a situation close to that of the leading financial countries. Italian banks, for instance, administer about 13 per cent of Euro-dollar funds. Lately, they have also taken part more frequently in issuing syndicates on behalf of foreign companies.

When the banks spread into the field of long-term credit, this means that they finance fixed capital formation by loans which, so far as the borrowing company is concerned, supplement or replace self-financing and funds raised on the capital market. The banks may lend to the user companies either directly or through taking up bonds issued by industrial, land and building credit institutes, or else by large agencies and companies which have direct access to the capital market.

If bank assets and liabilities are to increase through an extension of bank intermediation into a field which should really be the preserve of the capital market, it stands to reason that the rates of interest paid on deposits should approach the yield of the bonds which are their counterpart.

Now, this behaviour on the part of the banks certainly has something to do with the public's preference for more liquid types of asset. In New York, a market better organized than any European one, the banks have created an intermediate asset, the so-called certificates of deposit, which possesses a higher degree of liquidity than the capital market investments in which the banks concerned place the counterpart of these certificates.

Recent experience both in Italy and elsewhere shows that the banks are spreading into the long-term field both through direct loans for fixed capital formation and through larger security portfolios. The phenomenon is assuming large proportions and can be observed in many countries. Recent provisions in France make it clear that the monetary authorities there find it difficult to enforce respect of the demarcation line which should divide banking operations from those of the capital market, for banks have been authorized to engage in lending operations characteristic of the capital market and it is not excluded that the distinction may become blurred also on the side of deposits.

However, the two forms in which banks may enter the long-term field are very different from the point of view of risk selection and ultimate risk distribution.

As regards the first form, we in Italy have had our bitter experience in this century. We have seen how exceedingly dangerous it can be to mix up in one and the same institution the faculty to collect deposits and the right to lend them out in ways which directly involve the lender in the changing fortunes of each borrowing firm. We have learnt our lesson, and we have applied it in a system under which the task of granting finance credits falls to industrial credit institutes; these raise their funds on the market through bond issues within limits established from time to time by the competent monetary authorities, they must back their credits by adequate sureties, and their ability to rescue borrowing firms in a crisis is limited by the volume of permissible bond issues.

In the second form, when the banks acquire the bonds of large direct issuers, the risk is limited both to the extent that such bonds may be government-guaranteed and that they can more easily be sold on the stock exchange.

When the banks buy the bonds of special credit institutes, the two intermediary stages through which savings thus pass on their way from households to investing firms bring about an aggregation of selected risks which is akin to insurance. When the banks buy securities and so keep intact the deposits which the public might have used for the same purpose, depositors are in effect relieved of the risk of price fluctuations. When they buy bonds issued by industrial credit institutes, the banks acquire securities which guarantee a higher degree of liquidity, even though this may involve price fluctuations, and which have a built-in compensation of risks among different firms and sectors.

In the end, when the banks expand their intermediation by offering higher rates to savers with no definite preference as between deposits and securities, they do not fundamentally alter the division of labour between banks and special credit institutes in our system, provided the larger deposits find their counterpart in security investments and are not simply a forced attempt to make good a failure to reduce banking costs; nor do the banks thereby create conditions in which their assets are in danger of freezing, so that ultimately they can turn only to the central bank.

But the amount of bonds which can be placed with the banking system has its limits, and it is hard to see how these limits can be transgressed if we want to have a market in which bond prices, and hence yields, remain free to oscillate. Without a margin for oscil-

lation, bonds would become like money, and we would lose variations in the rate of interest as one of the mechanisms by which the demand for funds can be balanced with their supply. Even if the monetary authorities intervene to keep the oscillations within a narrow range, the banks may still be afraid of losses and hence limit their purchases.

Furthermore, while it is true that so far the banks have strengthened the public's liquidity preference by offering higher rates on deposits, it is equally true that they have also counteracted it by doing their best to sell bonds to ever-increasing categories of subscribers.

It is only fair to stress that if the banks are indeed invading the capital market, they are not doing so entirely on their own initiative. The growing financial requirements of the public sector have to be met by bond issues whose amount is laid down by law and cannot be adapted to market conditions; similarly, large funds are needed for investment programmes which cannot be interrupted, while firms encounter well-known obstacles in raising capital by equity issues. In these circumstances, it is necessary to place big amounts of bonds with the banking system and these, while they do hold back the rise of interest rates on the capital market, may exert upward pressure on those actually paid for deposits.

The process of organizational adjustments necessitated by the widening of the market has had, and will continue to have, its effects also on firms in the banking sector. Bank managers never lose sight of the need to lower the ratio between costs and the amount of funds administered; in certain cases, this may demand some change in the size of small banking firms, whereby they will gain in efficiency without losing their characteristic functions. I would regard it as a duty for us to contribute, by gradual steps, to the propagation of organizational innovations, in the conviction that this is one of the conditions of our economic system's continuing to expand production and thus to adapt flexibly to demand in a market without frontiers. The integration of our economy with the international economy in the financial sector may come to pass more quickly than we think; the remaining restrictions on the free movement of long- and short-term capital may disappear, and if this happens our country would come to occupy an important position in the international market – harking back, perhaps, to its role as the great centre of financial intermediation in the Renaissance world.

The Finances of the Public Sector and the Control of Internal and External Liquidity

The problems which the size and composition of public expenditure raise for economic and monetary equilibrium have been the subject of widespread debate and are discussed at some length in our Annual Report. In 1965, that portion of the increment in total demand which is attributable to spending by public administration was due, in part, to provisions adopted in 1964 and 1965 with the explicit intent of offsetting the deflationary effects of excess, idle savings; but the great bulk of last year's additional public expenditure fits into a steadily rising trend line and had little or no effect on the level of investment. Details of investment expenditures are available only for the government itself, and not for the other components of the public administration sector. Government investment expenditure was 1,439 billion last year, compared with 933 billion in 1964; of this large amount, close to 600 billion were disbursements for the liquidation of arrears due, that is, for projects belonging in part to the past.

Leaving aside 191 billion lire of direct investment and 501 billion of capital movements within public administration (transfers to the Cassa per il Mezzogiorno, local authorities, etc.), the remaining investment expenditure went to autonomous agencies (221 billion, chiefly to ANAS, the National Road Agency) which redeposited part of the sums with the Treasury, to increasing the endowment funds of IRI and ENI as well as certain revolving funds for government-financed credits (262 billion) and finally to transfer payments to firms and households (264 billion). It follows that a conspicuous portion of the sums formally counting as investment expenditure worked out its effects within administration itself, while at least part of those spent for the increase of endowment funds helped to raise the recipients' liquidity. The Report on the Economic Situation in Italy gives figures by which to measure the final impact of the public sector's direct investment upon the economic system, and we see that public administration and public enterprises invested less in 1965 than in 1964.

We ourselves have tried to estimate the probable effects of public expenditure on the money and capital market this year. To this end, we took the figures of the government's and the autonomous agencies' financial requirements as given in the Finance Act ap-

proving the budget for 1966 and in the special laws which authorize the government or autonomous agencies to incur expenditures covered by bond issues; we considered also relevant bills tabled, but not yet passed or under discussion in Parliament. We assumed that the disbursements of the Central Post Office Savings Fund for loans previously conceded, or to be conceded in the course of 1966, will exceed those of 1965 and that the flow of savings to the Fund will fall about 200 billion lire short of its disbursements. In this way, we arrived at a net figure of about 2,300 billion lire for total financial requirements, of which at least 1,400 billion will have to be met by government and other bond issues.

Between them, ENEL, ENI and IRI expect to float net bond issues of more than 600 billion lire, industrial and other special credit institutes will need 900 billion, and other agencies 100 billion.

In all, net issues in 1966 will have to come to 3,000 billion lire, compared with 1,971 billion in 1965; the corresponding gross issues work out at 4,100 and 2,475 billion lire. Now, whether we use econometric models or less refined processes, past figures suggest that issues of such an order of magnitude are bound to require more liquidity creation than would be sufficient to make sure of income growth at the projected rate this year in conditions of satisfactory price stability.

The above estimates may possibly turn out to be too high in case of delays in the approval of the law extending the fiscalization of certain social charges, as well as of the laws concerning the second Green Plan and school building.

The bill on fiscalization of social charges provides for the relevant expenditure to be covered by the issue of government bonds; but pending enactment, the payment of these charges by employers has been suspended, so that fiscalization had to be financed by monetary means. It was thought that the law might well be passed at a moment not so propitious for placing bonds with the public, and therefore it was regarded expedient to finance part of the budget deficit by public debt operations in April. As a result, banks experienced a temporary liquidity squeeze, which led some of them to disinvest lire employed in the Euro-dollar market. The bonds to be issued to finance payments to the social insurance funds, INPS and INAM, on the other hand, can in part be placed with money-creating bodies.

The bill launching the second Green Plan for agriculture has not yet been passed; supposing it is enacted some time in 1966 and that in the same year budgetary provision will have to be made for 150 billion lire, the Credit Consortium for Public Works would have to issue bonds in a like amount, given that the said appropriation is subject to the required funds being available in loans from the consortium. It seems highly unlikely that any disbursements will actually be made in 1966 against this new appropriation, and any consortium bonds placed with the public would therefore have a deflationary effect.

Similar considerations apply to the law on school building. Here, too, budgetary provision is subject to the funds being raised on bond issues, and actual disbursements are hardly to be expected this year. The requirements to be financed by Treasury certificates earmarked for INPS debt extinction will occasion offsetting receipts and outgoings if these certificates are taken up by the Central Post Office Savings Fund; but this would place further limitations on the Fund's lending capacity. It will, furthermore, be necessary to finance the current requirements of the State Railways plus their expenditure under the ten-year programme; both will probably have to be covered by bond issues in a combined amount of not less than 400 billion lire, since the provision of the Finance Act that the funds should be drawn from Post Office current accounts seems difficult to implement.

All in all, the timetable for legislation implying budget appropriations subject to prior fund-raising operations has not been, and is not now, consistent with any rational timing of monetary flows, such as would impart to public demand the volume it should have if it is to sustain balanced growth.

While government expenditure as a whole has been growing, an increasing portion of it has come to be excluded from the initial budget estimates and left to be covered by loans or bond issues. Thereby the unity of the budget is compromised and public expenditure keeps swelling in its passage through a number of secondary channels, which make the main flow look smaller than it is. The growing practice of using such procedures impairs the controlling function of Parliament and public opinion, in so far as it is harder to get an immediate picture of the overall deficit arising in government and autonomous agencies, as well as of the means of its coverage. Nor is this all. We have not only the uncertainties created by the absence of a single document recapitulating all these requirements and indi-

cating the sources to be drawn on for their coverage; we have also the paradoxical situation that the government may fail to honour its pledges to the nation in so far as budgetary provision for expenditure authorized by law is made subject either to borrowing the required funds from a credit institute whose own ability to issue bonds in turn depends upon whether or not the competent authorities regard market conditions as suitable, or else to withdrawing these funds from an institution like the Central Post Office Savings Fund, which may not have them and be unable to raise them. It may happen that expenditure commitments cannot be met for lack of specific funds; in that case, the deficit of public administration spills over into the budgets of public or private agencies which render services to it or on its behalf.

But the assumption that funds may be lacking is unrealistic. It is most unlikely that the state should exercise such self-restraint as to turn itself into the marginal claimant for funds. Higher interest rates or an expansion of the money supply, or a combination of both, are then inevitable to make the market absorb the quantity of bonds which the Treasury must issue, either in its own name or behind the screen of a special credit institute.

In some areas of the public sector, current expenditure exceeds current revenue. As a result, at least part of the additional flow of savings induced by monetary expansion fails to go into investment, but fills the savings gap evidenced by such deficits. When a deficit arises in the exercise of functions which, by their nature, have to be financed by taxation, this means that the community refuses to pay the cost of the services it demands from the public agency. When it arises in enterprises of the public sector which furnish goods and services to the market, this means that for some reason – having to do, perhaps, with organizational set-up, management principles, the level of employment and wages – the enterprise is ill adapted to market demand or that it subsidizes consumption for certain social groups.

Situations of this sort are steadily multiplying, and urgent government action is needed to revise them, think them out anew and set them right. This must be done if the public sector, as our economic development plan provides, is to play its due part in capital accumulation; it must be done for the moral imperative which demands that all production units should contribute their bit to the continuous effort of adjustment which is the rationale of all economic systems

based on rapid technological innovation and the consumers' freedom of choice; it must be done, finally, in the light of current developments even in centrally planned economies, which are now acquiring these elements of flexibility and in so doing might almost be said to recall them to the attention of the Western economies.

So far I have talked to you mainly of the financial requirements of the public and private sector, as the main determinants of credit policy. Now let us turn to credit policy itself.

We have exercised control of the banking system's liquid resources by measures which affected now its domestic, now its external liquidity. The banks' cash holdings of lire and foreign exchange were proportioned to the overall volume of lending and borrowing business at home and abroad. In the interest of better control over total liquidity formation, we altered the rules of permissible transfers between the two kinds of holdings and, to the extent compatible with these purposes, we authorized those of the possible combinations in the use of liquid resources which might maximize returns for the banks themselves and the whole system.

The balance-of-payments surplus in 1965 led to liquidity creation in the amount of 994 billion lire, of which 441 billion were absorbed by the banking system's net assets abroad. In November 1965, the Bank of Italy notified the banks that they might sell foreign currencies against lire only to the extent that these were in excess of foreign liabilities. The intention was to mop up the liquidity gain due to the acceptance of capital market securities as part of the compulsory reserves. In December, to help meet the habitual end-year financial requirements, the Bank of Italy authorized a net debit position abroad, which was reabsorbed the following month. The combined effect of the banking system's foreign exchange operations was an increase of 627 billion lire in its liquid resources.

In the course of 1965, the larger banks balanced their foreign position with the help of the Italian Exchange Office, which sold them spot dollars and bought back forward dollars. In January this year, we let the banks know that we would no longer be selling to those which had already balanced their foreign position. Any bank with excess lire holdings remained free to invest them in foreign currencies and to hedge the exchange risk by selling these currencies forward in the international market, within the permissible limits for such operations; but this might, and indeed did, result in a forward lira premium against the dollar. Effective returns from foreign assets

would then equal the rate of interest on the Euro-dollar market, less the premium.

The purpose of these measures was to avoid excess liquidity injections into the banking system. Without stopping intercommunication between the domestic and the international market, we took care not to let official interventions do anything to promote the spread of the prospective higher international rates of interest to Italy; if they had to spread to Italy, they were to do so only to the extent that market forces dictated through the play of forward exchange rates. In the event, bond yields did, during the first quarter of this year, rise in all European countries except Switzerland to levels higher than our own. As a result, Italian residents have been tending to repay foreign loans in advance, and non-residents are coming to look to Italy for loans and also bond issues. The effect was a deficit on capital movements rather higher than during the corresponding period of last year.

Liquidity control had the benefit last year of efficient co-ordination between the operations of the Bank of Italy and those of the Treasury. The combined deficit arising from the budget, from Treasury operations and extra-budgetary operations was 1,551 billion lire and was financed by public debt operations to the extent of 612 billion, while the Bank of Italy's autonomous operations diminished liquidity by 33 billion. The public absorbed 775 billion through an increase in the monetary circulation, in direct or indirect credits to the Treasury and in credits to the Central Post Office Savings Fund; 623 billion were paid into compulsory reserve accounts in correspondence with the rise in bank deposits. Including operations with other sectors, which had a liquidity-reducing effect of 66 billion, the banking system's liquidity rose in all by 68 billion lire.

To sum up, I think I can say that in 1965 the factors which determine bank liquidity were so co-ordinated as to reconcile two requirements: first, that the system should be kept liquid enough to enable it to buy securities on a large scale without having to deny credit to public and private borrowers, and second, that the banks should earn good returns on both their lire and their foreign exchange assets.

Securities owned by the banking system last year increased by 1,149 billion lire, or 38 per cent, and the bulk of the increment occurred in free portfolios. Domestic loans rose by 933 billion lire, or 7.2 per cent. The total supply of funds to the banks increased by

3,390 billion, of which 3,092 billion were accounted for by clients' deposits; the year's relative rise in the two cases was 15.8 and 17.7 per cent.

The increment of loans, deposits and total supply of funds was rather unevenly distributed among the separate banks that make up the whole system. Similarly, loan/deposit ratios were widely disparate and this explains the larger flow of transfers through interbank deposits.

If we insert into the banking system's consolidated accounts the estimated figures of credits and debits attributable to households, it becomes plain that the net liquidity gain of households last year helped to finance the increment in the public and private sectors' long-term indebtedness. Individual deposits with banks, net of individual debts to them, increased by 1,386 billion lire. The large public and private enterprises saw their net liquidity rise by 257 billion lire, and the medium and small ones by 561 billion. A small proportion of the liquidity gains in these sectors was transferred to the public sector, but much the larger portion of households' and companies' net liquidity served to finance the increase in the banks' security portfolios and cash holdings, both in lire and foreign exchange.

To make it easier for mortgage bonds to find a home, we authorized banks to invest part of their compulsory reserves in this type of security, which amounted in practice to freeing part of the reserves and thus increasing bank liquidity to the same extent. On 31 March 1966, banks had the right to use mortgage bonds in a nominal amount of 275 billion lire for compulsory reserves; at that date, they had applied for only 135 billion to be so used, and had, all told, 414 billion in their portofolios. These figures prove that the mechanism set up to facilitate the sale of mortgage bonds in effect created more funds usable for this purpose than the market absorbed. In other words, no financial obstacle has, in the immediate past, stood in the way of relaunching building activity. As of today, we have heard nothing of any debentures issued to back loans under the law of last November.

Company Finances and the Conditions of Recovery

Last year on this occasion, you will recall, I spoke to you of a survey we had done on costs and revenue in industrial companies. From it, it had become plain that revenue did not fully cover costs in 1964; I told you also that we found the profit and loss accounts of firms were slowly beginning to get back into better shape, and that at the same time there were the first signs of recovery in industrial production. But I warned that employment would fail to expand so long as labour costs per unit of output continued to rise, because firms would then be induced to go ahead faster with reorganizing production in such a way as to obtain a higher output per working hour.

This interpretation is confirmed by the latest Report on the Economic Situation in Italy. In 1965, gross domestic product at factor cost rose by 3.3 per cent in real terms, employment fell by 2 per cent, output per employed person increased by 5.4 per cent in real terms and by 9.2 per cent at current prices. Dependent labour incomes rose by 6.7 per cent in global, and 9.5 per cent in per capita, terms; the latter increase corresponds to 5 per cent in real terms. The largest increases occurred in the so-called Other Activities (other, that is, than industry and agriculture), in which public administration predominates and where income per person employed rose by 12.3 per cent in nominal and 7.7 per cent in real terms. Industry stood at the bottom of the range with a nominal per capita rise of 6.7 per cent, exactly matching the increase in gross output per person employed in industry. On the average of 1965 labour costs per unit of output in industry fell as a result of the government's taking over part of the social charges payable by employers, and the year-on-year December figures also show a falling tendency. The deterioration in company profits came to a halt and the most recent figures suggest that employment is beginning to go up.

Today, we have examined together the composition of financial assets and its changes since the establishment of the European Economic Community. We saw that companies in the public and private sector alike have been incurring mounting debts to supply themselves with finance funds, while the proportion of shares in total financial assets steadily fell. These conclusions are drawn from the supply side of finance funds; to verify them on the demand side, we

have the results of an enquiry covering the balance sheets of a representative sample of manufacturing companies. These figures confirm that the companies do in fact have a growing burden of fixed charges; during the three years 1959-1961 they self-financed 60 per cent of their gross investment, during the following three years 1962-1964 only 39 per cent, and for net investment the corresponding percentages are 36 and 14. It follows that during the later period virtually all new investment was financed with borrowed funds. In detail, metallurgical companies covered 30 per cent of their new investment by self-financing during the first three-year period, and barely 3 per cent during the second; for chemical companies the figures are 26 and 18 per cent. Last year, the fall in investment had the result that a larger proportion of it was covered by self-financing.

With such heavy financial charges already to pay, companies become less willing to proceed to new investment which involves them in further heavy borrowing. Companies with a low ratio of equity capital to total capital invested are more vulnerable to the danger of falling into foreign hands, and the more so when they enjoy tempting government subsidies. I have had occasion to say, in another context, that joint production agreements between Italian and foreign firms were all to the good, provided they helped broaden the market and introduce new techniques; but when a takeover is the result simply of the ease of acquiring control over a debt-ridden company, then I share the apprehensions of those who feel that this is not in the general interest.

If we want to expose our system of production to the stimulus of international competition, but not to the danger of passing out of our control, then we must strengthen the financial resilience of the companies which go to make up the system. We must take measures to make management more flexible by encouraging venture capital to come forward and hence limiting the further growth of indebtedness. To this end, we need a tax system which does not fundamentally distort the relative costs of the various forms of finance. As things are at present, the structure of net yields the investor can get on various securities is such that companies are virtually forced to choose loan capital, and the more so when it is associated with special facilities; nor can this yield structure be altered in the short run, because it is an expression of definite preferences on the part of investors. Unit trusts, or investment funds, would be one institutional remedy, and so long

as the relevant legislation is not enacted, there will be a risk that the control of companies, instead of possibly passing to national institutions, might in some cases fall to foreign interests. We are still waiting, too, for the enactment of the law on safeguarding competition.

Other ways to strengthen Italian companies are to encourage them to branch out into the world's expanding markets, for instance by such means as the recent agreement on the participation of Italian industry in the development of motor car production in the Soviet Union, or else to promote mergers such as took place in the past in the steel industry and more recently in the chemical industry. In this latter case, the general interest was taken care of by vesting a considerable number of shares in the public sector and by stipulating appropriate provisions in the merger contract. Generally speaking, large concerns do more than medium-sized companies to promote research and to develop new, original products, because they can spread research risks over a larger volume of production and, as the accounts of the large steel and chemical concerns make clear, devote sizeable parts of revenue to such purposes.

Technological progress, especially if it is fast, does not spread through all sectors of the economy at a uniform pace. These differences set off a wage race, in which the sectors with the highest productivity pass their wage rises on to the rest of the economy and then press for yet higher wages to regain the lead. In the absence of a co-ordinated policy, therefore, average wages tend to rise faster than average productivity, the resulting increase in costs depresses profits to the extent that it cannot be absorbed in higher prices, and ultimately investment contracts. This is the sequence which Italy was not the only country to experience in recent years. The correction of these intersectoral imbalances requires collective negotiation, in which organized labour is called to assume responsibilities not limited to specific aspects of wage policy, but extending to the whole field of economic policy of which wages policy is an integral part. If the trade unions are so intent on raising labour's income share that they act without due awareness of the macro-economic consequence of their behaviour, then the system reacts by an adjustment process of its own, whereby equilibrium at the level of the firm is re-established by a fall in employment. It is a sort of incomes policy in reverse.

Our system of production is in no condition to support any alterations in the distribution of income among factors of production

which would further raise the share of labour. While it is true that the deterioration in company profits came to a halt last year, firms have not regained a position in which they can effectively withstand international competition and at the same time renew their plant at the necessary rate without incurring excessive debts. It should be added that it is quite wrong to regard the surplus in our current balance of payments as excess saving; in some part, which cannot be measured, it derives from sales at prices making no adequate allowance for depreciation. I do not mean to imply, by what I have said, that wage rises are to be excluded; but I do want to indicate the limits within which they must remain if the level of employment is to be safeguarded.

In these conditions, quite exceptionally heavy responsibilities fall to public administration at all levels, on central and local government, on government agencies and enterprises. Wages policy with respect to the employees of public administration must become a factor of equilibrium in the economic system. If wages in the public sector were to go on rising at a pace faster not only than real income growth per head but even than nominal wages per person employed in the rest of the economy, the effects would soon spread throughout the whole system and they would be evident not only in labour disputes but also in the broader context of the appearance of forces tending to alter the very structure of our economic system. Along the border line between the public and the private sector, there would be increased pressure for changing over into the former, which would more and more seem to promise immunity from the demands of economically rational management. Instead of going forward in the direction of raising the efficiency of the system as a whole, we would be exposing the unprotected sectors of production to a strain they could not bear for long, so that they, too, would ultimately be attracted into the public sphere.

It is a highly doubtful question, furthermore, whether we can go on with the practice of transferring social charges from companies to the government, if this is to be financed by the methods used so far. These methods really amount to reducing taxes on production and covering the resulting shortfall by public loans. When there is an abundance of uninvested savings, such measures may be consistent with the objectives of an economic policy which accepts the constraints of balance-of-payments equilibrium, price stability and a stable exchange rate; but they must not become part and parcel of

a system in which public expenditure responds to continuous expansionary stimulants. Situations may well occur in which the deficit of public administration cannot be financed without detriment to the stability of rates of interest, and in that case the burden would simply be shifted back to the process of production, since it would have to be financed at higher cost.

Nor can the level of employment be durably sustained by an expansion of public expenditure if the latter should be due, as in fact it has been, to direct and indirect personnel costs and transfer payments to households. Swollen discontinuously by the liquidation of arrears due, public expenditure erupts like a torrent in flood; it is far indeed from being an expression of the type of policy which attributes to expanding expenditure the gift to call forth new combinations of idle factors of production and to spread reviving impulses throughout the whole economic system. In 1965, public administration raised net current transfers to households by 929 billion lire and incurred new net debts of not much more (1,164 billion); at the same time, the households' propensity to save increased. Public expenditure should have had a compensatory effect at a time when private expenditure was deficient in comparison with production capacities, but at least part of that effect never came off. When the level of demand falls it may, in the short run, be indifferent whether public intervention works through consumption or investment. But long-period considerations, in which problems of development must prevail, make it imperative that idle resources should, to the extent possible, be employed for productive purposes. It must be added that it is hard to see how this could be done, to the desired degree, with the system of public administration we have.

The ability of public administration to adapt its spending to countercyclical requirements has widely been called into doubt, and rightly so, as the events of 1958-1965 prove. During that period, the expenditure of public administration rose at an annual rate of 12 per cent, and that of government by 13 per cent; in the boom, the pace was seen to be quickening. The reasons for these shortcomings are common knowledge; not the least of them is the difficulty of co-ordinating the decision centres responsible for local authority spending, which accounts for about one-quarter of the entire public sector's consumption. Because its direct investment is rising so little, public administration instead steps up transfer payments to other sectors, and so leaves them responsible for investment decisions.

Public expenditure should make the wheels of the economy run faster, but is itself slow and cumbersome, and in the meantime piles up commitments for expenditure to be financed by debts which constitute a heavy mortgage on the capital market of future years. Allowing also for the bond issues required to finance the fiscalization of social charges by the present method, legislation now on the statute books or about to be enacted will require government and other bond issues well in excess of 1,000 billion lire in each of the next few years, and this takes no account of whatever issues may be needed to finance the budget deficit and the deficits of local authorities and autonomous government agencies.

The greatest uncertainty surrounds the timetable of legislation authorizing expenditure to be covered by bond issues on the market, and, together with the tangle of arrears due and receivable and their unpredictable effects on cash movements, this makes it doubtful whether the cash flows of public administration can be co-ordinated according to a programme which can serve as a reference base to those responsible for the management of the money supply. We simply do not have the information needed for reliable simulation in an econometric model, and we cannot be sure that the figures so obtained are consistent among themselves and with the income figures. It must be added that all the econometric models we know of connect the various magnitudes on the basis of coefficients resting on the observation of behaviour patterns during a period of – often fundamental – structural change.

To some extent, the very dexterousness with which aggregates are manipulated today helps to relegate to the background the more detailed problems of ordinary administration, yet there are some among them which have long waited for an overdue solution. The resulting uncertainty does nothing to enhance the efficiency of those authorities which have to take action. The debates on the need to intensify investment offer a telling example: they abounded in arguments drawn from the most modern economic theories, but were sadly lacking in factual indications concerning the nature of the investment, the obstacles standing in its way, and possible administrative remedies.

In the absence of information on which to base reliable predictions for 1966, it does nevertheless seem unlikely that gross public investment will rise appreciably beyond 1965 levels or that public enterprises will invest more than last year. Any increments of total

investment will therefore have to come from companies in the private sector, among which those in engineering and chemicals are expected to lead and those in textiles to play some part. Textile firms have gone ahead, and are still doing so, with thorough reorganization without the benefit of the government measures which were announced so long ago. Medium-sized companies are to play a prominent part in these schemes, provided they get adequate credit, as surely they will.

The base industries invested so much in recent years that some falling off must be expected in the immediate future. This seems the right moment, therefore, to step up public investment in infrastructural services, more especially in transport and communications, and in rationalization schemes in the areas complementary to agricultural activities. There is no case, on the other hand, for trying to raise the level of public investment by venturing any further into other sectors, including especially manufacturing industry. All that would happen is that the government-controlled companies would compete with private entrepreneurs and would so upset the very base of their economic calculations that the effects are hard to foretell.

As regards the prospects of recovery in building activity, available indicators give scant comfort for the immediate future. However, the Bank of Italy and the Central Statistical Institute have started, though not yet completed, a large-scale survey on this subject, and first indications are that in the main cities and adjacent parishes there is not nearly as much unsold residential property as is commonly said.

Foreign demand continues to exercise an impulse effect on our economy. The rise in imports so far this year confirms that the recovery is gaining ground, exports are still on a steady upward course, and prices have, on the whole, been stable. The current improvement in company earnings, together with export growth, is stimulating directly productive investment to the point where unemployed labour is being reabsorbed more quickly. In the event of durable cost stability, this effect would soon be propagated to the entire economic system and we could then look forward to keeping the Italian economy's growth rate one of the highest in Western Europe.

* * *

I have spoken to you today of some functional deficiencies which in the recent past have impeded, and still impede, more harmonious coordination between the public and the private sector of the economy in the pursuit of the targets of our economic plan. But, as I see things, these very deficiencies lend added force to the plea that the plan's fundamental intent of impulse and renewal should not be allowed to fritter itself away in the sterile contest between preconceived ideas and unrealistic zeal.

There are cases where public intervention, far from hindering or frustrating private enterprise, is an indispensable condition of its greater efficiency. Our economic plan sets forth as one of its guiding principles that we must make good the deficiencies and imbalances due to the inadequate satisfaction of certain essential collective needs, in fields ranging from public health to education at all levels, from vocational training to scientific and technological research; in so doing, it truly breaks new ground and beckons us to tasks whose overriding priority is beyond doubt, if we want to create the foundations from which our people may move forward to new goals of social advancement. To recall this challenge to our minds does not imply wishing to confine public economic action within narrow bounds; on the contrary, it serves to underline the close link which exists between our country's future progress and our own ability, today, to accept inevitable limitations, to make our choices with determination and translate them quickly into achievements.

In the first Annual Report which it was my privilege to present to this Assembly, I said towards the end: "our economy has run ahead of its own institutions". Five years have passed since then, and they have brought profound changes in the structure of Italian society. The wave of the business cycle has risen and fallen, and is now turning again, but through the changing tides we can perceive a true line of uninterrupted progress at the level of the firm, of organized labour, of local government. In our institutions, however, this line is faint and hesitant, as if to suggest that they have not overcome their suspicion of modern ideas and stand incredulously on the sidelines of the march of time.

In the public and in the private sector of the economy alike, firms have built factories incorporating the most advanced techniques and they stand ready at all times to introduce new organizational improvements; they link up with firms in other sectors and with foreign concerns and adapt their size to the requirements of steadily

expanding markets, while independent entrepreneurs, with courage bordering on recklessness, enter a contest in which the merits of action are judged solely by its success or failure.

We have in our country intrepid spirits who, without being obliged to do so, freely accept the conditions in which the genius of invention is sharpened on the whetstone of growing risk in a market stretching to the four corners of the earth. More and more choices are open to producers, to workers, to consumers, to intellectuals, who thus become less dependent upon the conditions of their environment and gain more freedom to live according to their own bent. The Italian government's unswerving adherence to the purpose of European unification reflects our conception of how, in the new order of European society, a people not devoid of merit can rise to a higher level of existence.

It is in the setting of a united Europe, open to competition from all directions, that our credit system finds its place as an efficient instrument of modern monetary policy, always ready to adopt new methods. Its task is to give the Italian economy a capital market of European dimensions, and to supply it with short- and long-term credit on terms which stand comparison with the most advanced industrial countries. In close collaboration with you, gentlemen, we keep the system under continuous critical review for our common purpose of introducing every improvement of which it is susceptible. Both you and we fulfil our duties in a spirit of unconditional loyalty to the system, and it is this spirit which enables us to face the tasks of the future with sober confidence.