Concluding Remarks for 1967

It is not always that a review of economic and monetary trends can be kept within the brief space of a single year, or within the narrow limits of a single country's territory. That is why my attempt to analyse and interpret those trends is going to lead me outside the limits of time to which this Report is supposed to conform, and also outside the geographical boundaries of Italy.

The frontiers which separate the domestic from the international market are becoming blurred by the increasing integration of the various economies, even though recent events may appear to be interrupting the continuity of that process. I refer in particular to the restrictions on transferability of the dollar, as well as to the progressive loosening of the monetary links between the countries which form the sterling area.

World trade has greatly expanded during the past ten years; the growth rate of such trade, especially between the industrial countries, has remained consistently above that of production. This would not have been possible without the abolition of quotas, the lowering of tariffs, the multilateralisation of payments, the convertibility of currencies and the preservation of fixed exchange rates. Movements of capital have also been liberalised, although in lesser degree than exchanges of goods and services. These processes were fostered by the establishment of the European Economic Community.

Once the convertibility of European currencies had been restored, towards the end of 1958, monetary authorities tried to ensure adequate creation of international liquidity. Evidence of this is to be found in the increases of International Monetary Fund quotas, in the General Arrangements to Borrow concluded with a view to providing that Fund with additional resources, and in the steady widening of the network of swaps between central banks. Finally, the Stockholm agreements, sanctioned by the Fund, provided for contingency planning for reserve creation on the occurrence of certain conditions, which include better equilibrium in the external accounts of the reserve currency countries.

During the period between 1950 and 1967 the world's total monetary reserves grew from 49 to 73 billion dollars, that is by 50 per cent; at the same time, world imports grew almost fourfold, rising from 58 to over 200 billion dollars. The reserves of countries other than the United States increased by 140 per cent, from 24 to 58 billion dollars; the gold component increased by 16 billion dollars, of which 6 billion reflected acquisition of newly-mined gold while 10 billion originated from losses suffered by the United States. The total fiduciary component of those reserves increased by 18 billion dollars. Of this amount, 13 billion dollars consisted of convertible currencies, mostly dollars created by the deficit on the American balance of payments; the rest was in net IMF positions, partly reflecting indebtedness of the United Kingdom. The growth rates of the various components diverged quite widely during the period under consideration; in particular, the foreign currency component increased, during the 1960s, eight times as much as gold.

These figures appear to confirm, on the one hand, that the need for international liquidity has not become any less. On the other hand, they show that the growth of reserves mainly depended on the deficits of the United States and of the United Kingdom, that is on a process representing an element of weakness both in the system and in the position of those two countries. These two considerations have provided support for those who criticise the working of the international monetary system, and for the proposed reforms.

One condition for the proper working of the gold exchange standard is, of course, that the amount of gold held by the reserve centres shall increase in a certain proportion to the growth of their short-term liabilities. Another is that the supply of gold shall be enough to enable the other countries to maintain expansion of the gold component in their reserves at a pace commensurate with that of those reserves as a whole. During recent years, these two conditions have not been fulfilled; with gold scarce, the United States has become its residual supplier.

Gold and the Future of the International Monetary System

Some critics of the United States' economic policy attribute the present troubles of the international monetary system to the fact that the American authorities have, on the one hand, financed their country's external deficit by issuing dollars, but on the other hand have kept the price of gold unchanged, thereby aggravating the shortage of that metal. Now, those critics say, the American authorities have in the end been forced to protect their reserves by keeping down the supply of dollars through a monetary policy tending to raise interest rates; they have also been compelled to adopt measures which restrict the import of goods and services, thereby harming the countries which would have exported them. The critics go on to conclude that it should be sufficient to increase the price of gold to solve all problems without deflation, without quotas or similar controls, and without open or concealed multiple exchange rates.

It might appear that the correctness of this conclusion had been partly admitted when it was decided at Washington, in March, that a two-tier gold market should be set up, one for central banks dealing at the fixed price of 35 dollars per ounce, the other for the private sector, dealing at prices determined exclusively by demand and supply.

Now it is quite true that the gold pool, from the time when it started in 1961 until 1965, did not cause the central banks operating it to suffer any loss of gold. But as long ago as in our Report for 1962, having realised that the London gold market performed no useful function from the monetary point of view, we pointed out how illogical it was to provide machinery which would satisfy without any limit the requirements of private hoarders and speculators, while efforts were being made to limit so far as possible the conversion of dollars into gold in dealings between central banks. We suggested that, in the quite near future, the central banks would find themselves confronted with a difficult choice. Should they continue selling gold to the market, thereby depleting their reserves and finally raising doubt about whether the price of 35 dollars per ounce could be sustained? or should they cease to sell gold, thereby indicating that speculative pressure had become so strong that the central banks were forced to abandon the market? At the present time, everybody knows what speculative movements followed the devaluation of sterling.

The net result was that the central banks lost gold to the extent of 1,500 million dollars up to 31st December 1967, of 240 million dollars in the first two months of this year, and of a further 1,270 million dollars in the first two weeks of March.

At an earlier date, the Bank of Italy had suggested a two-tier gold system, which was to be done on the basis of suitable understandings between central banks. Appropriate arrangements would have limited the possibility of gold leaking from the official circuit into the free market; and speculators would have been deprived of the floor price which safeguarded them, in any event, against capital loss.

The Washington decisions, while meeting current needs, form part of the continuous process which has been reducing the monetary function of gold, first within individual economies and then on the international plane. Those decisions resulted from the need to prevent the outflow of gold from central banks into private hoards from becoming so great that the gold exchange standard would be transformed into a dollar standard. Central banks taking part in the agreement no longer feel it necessary to acquire gold, except in the course of transactions between themselves and other central banks. The result must be to keep the quantity of monetary gold virtually unchanged; and that in turn must reduce in due course the importance of gold as compared with the other reserve components.

Nevertheless, the solution selected has restarted the argument about possible alternatives. Some critics argue that, since the price of gold has been kept unchanged ever since 1934, the metal has become too cheap in comparison with goods. This fact, they say, has progressively aggravated the shortage of gold; during recent years, it has also increased the inclination of central banks to switch their reserves into it. A uniform increase in the price of gold, they suggest, would in itself tend to reverse such behaviour; it would therefore be the best way to supply the market with international liquidity.

But one upward revaluation of gold might well be regarded as merely the first of a series; it might tend to make people feel that a deficit, capable of being financed with smaller and smaller quantities of gold, could persist for an indefinite space of time. The truth is that those critics in the United States who advocate this solution are generally guided by considerations the opposite of those which inspire supporters of the same proposal in Europe. The Americans who advocate an increase of the price for gold are expressing an opinion widely held in their country. They favour this idea simply in order to release the United States from the constrictive need to redress their balance of payments. Yet the United States' authorities responsible for monetary policy are quite conscious of that need. Thus, an increase in the price of gold would suit the book of some financiers on both sides of the Atlantic. These people want to expand the business done by their own institutions. That is why they favour an easy dollar policy, and they make this sound respectable by wrapping it up in talk about the virtues of gold.

Other people propose to increase the price of gold in order to deprive the dollar of its function as a reserve currency, and to prevent it from financing the American deficit in future. The first step would be to revalue gold upwards enough to give the United States a gain in value, on their stocks of gold, which would enable them to buy back the whole of the dollars now included in the reserves of central banks. Thereafter, periodical upward revaluations of modest amount would suffice to meet the needs for additional liquidity.

The use of gold as the only medium into which the foreign currencies held by central banks could be converted would not only mean abandoning the progressive policy implied in the Bretton Woods agreements. It would also mean returning to the pure gold standard which operated in former times. It certainly appears specious to make any distinction between the nineteenth century gold standard, based on internal convertibility, and the proposed new standard based on convertibility for external purposes. If there is to be a channel connecting the monetary circuit to the commercial circuit for gold, then the two forms of convertibility mean the same thing; if the export of capital is free, any resident who could not convert his own currency into gold at home could do so on any foreign market.

To propose such a system merely in order to harm the countries which issue the reserve currencies is no responsible solution for one (and not the least) among the many domestic problems, and problems of international co-existence, which confront us at the present time.

Apart from the immediate consequences of raising the price for gold to the extent suggested, it is not certain that the growing demand for monetary purposes could be met in the course of time through successive, periodical upward revaluations; these would, on the contrary, produce the perverse effect of encouraging private hoarders. In the course of competition between central banks and the private sector to acquire gold the central banks would defend themselves by raising the price, thereby causing everybody to expect that the price would be still further raised. In the long run, the stock of monetary gold would decrease. The only way in which the authorities could react to this would be through deflation, quotas and similar restrictions, exchange control, and finally by detaching their currencies from gold and going over to a system of completely free exchange rates. That indeed is a solution which some critics have immediately adopted. If that were done, they argue, international reserves would be no longer needed; the market's function, namely to determine the price for each currency in terms of the others, would have been fully restored. The argument about whether there should be fixed or flexible rates of exchange is essentially about a question which has been incorrectly stated. If the choice were stated as being between stable and unstable rates of exchange, most people would at once conclude that the growth of world trade, and the international movement of capital for investment purposes, require that uncertainty shall be reduced to the minimum. In other words, they require stable rates of exchange.

A further point is that the forward exchange markets have grown up under a system of fixed exchange rates; they could hardly function if there were free rates of exchange. This trouble, indeed, disappears if rates of exchange are regulated by central bank action. But in that event the central banks will again need reserves; in fact they will, if anything, need reserves greater than before.

With a system of fixed exchange rates the opposite applies. The monetary authorities, by declaring their intention to defend the parity at a given level, render the market's expectations less variable. The central banks prefer such a system not only because of its international implications but also because of what it means on the domestic plane. The point is that, if rates of exchange are fixed, the authorities responsible for economic policy are under special compulsion to avoid price inflation, or to keep it down to the average international level. If there were no such external compulsion, and if sliding-scale wages were general within the country, there would be a stronger tendency for prices to rise, while the authorities would be less concerned to defend the currency's purchasing power.

Our position, to sum up, can be briefly stated as follows.

Expansion of international trade must take place in conditions of freedom from quotas, and from other restrictions, and must be assisted by progressive lowering of import duties. Payments must be made, under a multilateral system, in currencies which are freely convertible on the basis of fixed exchange rates.

To this end, the existing reserves must be supplemented by new media created as result of decisions, to which each country shall contribute according to its importance in international trade. The international money supply must be capable of constant adjustment to accord with the growth of trade, and the reserves of international currency held by individual countries must contract and expand according to fluctuations in their balances of payments; but the sources from which that international currency originates, and spreads through the markets, ought not to be the mines from which a metal is extracted. The system must include effective incentives to ensure that imbalances shall be redressed without interrupting the growth of incomes and of world trade. It follows that the international liquidity, created multilaterally within the IMF and bilaterally through agreements between central banks, shall be of an amount sufficient to finance such transfers of capital as may take place between the various markets, particularly when speculative expectations might appear.

The agreement on amendments to the IMF's Articles of Agreement, as submitted for formal approval by the member countries last April, adopts several suggestions put forward by Italy. The reform provides that, besides the conditional credits previously available, there is to be a system of automatic credits described as special drawing rights. These will supplement central banks' owned reserves and will be available for use, according to specified procedures, on an even level with these reserves. The new reserve assets will be progressively incorporated in existing monetary reserves; it follows that the proportion of gold, dollars and sterling will decline.

This reform does not solve all the problems. In particular, it does not solve those which originate from the instability still inherent in the gold exchange standard; this remains subject to pressures which may result from the conversion of sterling into dollars, of dollars into gold and, in general, of one reserve component into another. From that point of view we say, once again, that a common reserve policy needs to be worked out. It should coordinate the use made of the various reserve assets. A promising start has been made, on those lines, in the standards laid down for management of the special drawing rights.

The building up an international monetary system based on the exclusion of all privileged position requires alongside other aims such as a closer link between Eastern and Western Europe. One fact which limits expansion of trade between East European countries, and between them and West European countries, is that the relevant payments have been based, and continue to be based, on bilateral equilibrium.

Italy's trade with those countries, and in particular with the USSR, has been assisted through our granting of large loans; if the credits promised are added to those granted during the last four years, the resulting total is greater than that of the deposits in dollars, plus the certificates in dollars with a lira exchange guarantee, which we accumulated during the same period. But, whereas the credits granted to the USSR provide for redemption spread over a certain number of years and cannot be mobilised before maturity, those granted to the United States are sight assets which can be spent anywhere. It is therefore necessary to move forward, in the financing of trade with the USSR and with other East European markets, to systems based on claims which shall be wholly or partly transferable. If those countries joined the International Monetary Fund, this might quicken the movement in that direction.

The reform of the IMF's Articles of Agreement lays the foundations for progressively concentrating all monetary reserves in one institution within which the functions connected with regulating international liquidity might be more fully performed. Within its framework, it should be possible to effect the payments which would originate from expanding trade between countries that have the most widely differing political systems. In official quarters abroad, there has been talk of possibly establishing, at the International Monetary Fund, what are called conversion accounts. It would be possible to deposit on these accounts any balances in dollars, and possibly in sterling, which central banks might consider to exceed those which they required for operating in the foreign exchange market.

We must aim at attaining this objective, while we remain fully aware of the obstacles which stand in the way of its attainment. Strong pressure groups resist the adopting of solutions based on common sense; they call for an increase in the price of gold, so that the resulting abundance of metallic reserves may release the monetary system from the constraints to which it is now subject. These people discuss about the true price, and the false or artificial price, the true price being the one which they would like to impose. Other people suggest a paper dollar carrying a gold guarantee; they appear to feel that on this basis there could be a continuous and unlimited supply of dollars, which would permit perpetual deficits "without tears".

The Crisis of the Reserves Currencies and the Responsibilities of the International Community

During the last decade, the attitude of continental Europe towards the external deficits and the economic policy of the United States appears to have been influenced by considerations of two following kinds: the effects produced on the European economy by the afflux of dollars, and the American failure to apply the remedies adopted in Europe for dealing with a deficit on the balance of payments.

In the Report presented in 1966 we expressed our view that one reason for the concentration of foreign exchange reserves in the European Economic Community countries was that their central banks preferred to meet monetary base requirements through external rather than internal operations, while another lay in European savers' marked preference for liquid assets. This explanation does contain an element of truth; but it disregards the fact that satisfaction of the demand for reserves was possible only because the United States increased the supply of money.

It has been argued that the disequilibrium in the United States' balance of payments caused, in Europe, an excess demand for goods and services coupled with adverse effects on the price level. But the United States' balance of trade has been clearly in surplus, and it does not appear that Europe has suffered from any excess of investment due to afflux of American capital; the pull exerted on European demand would therefore seem to have been only indirect. Since the external surplus is reflected in an increase of the monetary base and of intemal liquidity, the threat to price stability would appear to have resulted precisely from this undesired expansion of the money supply. But, even if the logic of this reasoning were irrefutable, it is also true that the central banks of the surplus countries could have carried out offsetting operations.

Instead of that, the European central banks not only accepted the expansive effect resulting from the increase of their external assets, but actually reinforced that effect by increasing their domestic assets. They felt that by this means they must supply their economy with the liquidity required for maintaining economic growth at a high level, thereby implicitly admitting that they were prepared to pay for it by allowing a rise of prices.

There is a further reason why some critics have been dissatisfied. It is that the United States have been able to escape the discipline to which European countries with deficits on their balance of payments have been subjected in the recent past. Even though the United States has had a large external deficit ever since 1958, it has continued to give priority in its economic policy to an increase of the degree of utilization of available production factors. In Europe, on the other hand, on the emergence of any external imbalance the responsible authorities have been afraid that it might become chronic, and that they would therefore be unable to maintain their declared parity of exchange. This has almost always led them to restrain domestic demand in good time, so as to redress the balance of payments, even at the cost of slowing down production. That was the policy pursued by Italy in 1963-64 and by Germany in 1965-66.

In referring to those experiences we do not ignore the greater difficulties of the American problem. Those difficulties are partly due to the very fact that the deficit has lasted for so long, and this has accustomed the rest of the world to relying on a certain amount of demand for goods and services as well as on American investments in foreign countries. From the angle of domestic equilibrium inside the United States, the difficulties result, more particularly, from the extent to which real resources would have to be switched to increase exports. The difficulties arise from the fact that certain internal uses of resources, like those for the armed forces and for investment of a social character, display a rigidity which cannot be overcome without exercising fundamental options and without risks in aggravating the existing tensions. A further point is that the ratio of imports to the national income is rather low in the United States, while that of American imports to total world trade is relatively high.

In the light of those rigidities, plus the fact that the American external deficit results from the current account surplus not being large enough to offset the export of capital, it is understandable that, when the authorities did finally try to eliminate that deficit, they directed their actions to reducing total direct investments abroad or at least the burden of financing them. They switched that burden to European markets, thereby rendering more difficult the problem of how to maintain equilibrium in these. By so doing, however, they did make it possible to maintain total investment in our economies at a level which was probably higher than could have been attained if the contribution of American undertakings had been blocked.

The demand for credit inside the United States, coupled with the restrictions introduced by the Federal Reserve System, have raised American interest rates and thereby attracted capital from the rest of the world. The mechanism through which changes in rates at New York spread to Europe, and through which American companies finance their needs abroad, has been provided by the Euro-dollar and Euro-bond issue markets. These compete with individual national markets for the supply of funds, and ultimately transmit to them the effect produced by the strains in the United States and by the measures adopted there. It must be borne in mind that, in terms of flows, each of the two largest European capital markets are equal to only one-eighth of the corresponding market in America. This clearly reveals why the consequences on European stability are particularly serious.

In certain circumstances the sensitivity of the Euro-dollar market, and the order of magnitude of the operations taking place in it, increase the danger of disturbance for national banking systems. The consequences of transferring funds differ according to whether the foreign position of the banks in the country from which the funds are taken is in surplus, in balance or in deficit. In the first two cases the pressure is transmitted to the foreign parties concerned, thereby creating a possibility of bankruptcies; in the third case it also extends to the reserves of the central bank. In some countries there was a threat of a banking crisis due to transfers of such a kind on the devaluation of sterling. The central banks reacted with a coordinated policy, directed to guiding the flows of funds into the Euro-dollar market, and implemented it by a suitable combination of spot and forward transactions.

We have thus stated the internal and international obstacles which stand in the way of restoring balances of payments to equilibrium. By so doing we do not imply the conclusion that the United States authorities ought to refrain from regulating the size of monetary demand in such a way as to set a limit to the extent and persistence of the imbalance. In other circumstances, we believe we have produced evidence that the inflationary processes in Europe are largely due to factors inherent in the mechanism of current development where an incomes policy is rejected. But, if the United States continued to have a balance of payments deficit similar in size to that which they had during the second half of 1967, this might make it difficult to pursue autonomous monetary policies.

There is a general feeling that the United States should be responsible for transferring to the rest of the world, in the form of government expenditure, aid and foreign investment, approximately 1.5 per cent of their national income. This means that, in present circumstances, they ought to be exporting net real resources equivalent to nearly 12 billion dollars per annum. We believe that the American economy is strong enough to meet that condition, and to restore the balance of payments to approximate equilibrium; we further believe that this can be done without any need for changing present currency parities, for recourse to multiple exchange rates, or for quotas and similar restrictions. But the extent of the improvement which the United States must achieve for that purpose in their external accounts, given the difficulties which we have just pointed out, is such that the necessary process of adjustment is bound to take rather a long time. An unduly abrupt reduction of American demand, even if it could be achieved, would impair the continuity of economic development not only in the United States but also in the rest of the world. From another point of view, if the United States refused to submit to discipline involved in the process of adjustment, the maintenance of monetary convertibility at the present parities would make it inevitable, for the reasons mentioned, to reduce the volume of transfers to a size corresponding to that of the real exportable resources.

In the absence of sufficiently strong action to contain domestic demand, an attempt could also be made to effect the adjustment by changing the parity of the dollar in relation to gold. But, in all probability, the other countries would change the gold parity of their currencies to the same extent, so that their rate of exchange with the dollar would remain unaltered. In that case it is difficult to see how the surplus countries could refuse to accept more dollars in their reserves.

If this conclusion were rejected, the impatience felt by many of us might lead to the adoption of one alternative solution which has been considered. This would be to widen the spreads for the dollar quotation, as compared with the official parity, or simply to abolish those spreads and to make the dollar inconvertible. In that event, the EEC countries would find themselves facing a dilemma. Should they maintain the exchange rate for their own currencies unaltered, and accumulate dollars without limit? or should they allow their exchange rate to fluctuate according to demand and supply in a single market, or in two separate markets, one for current and the other for capital transactions? The EEC countries would, of course also, have to work out what the effect on the future state of the Community would be if they did not act all in the same way.

Another solution contemplated is to tighten the economic and monetary links between the EEC countries, establishing rigid relationships between their currencies, which would fluctuate together in relation to each other. Since we are convinced that the economic progress of Italy is, and will continue to be, promoted by its taking part to the fullest possible extent in international trade, we do not believe, therefore, that substantial monetary autarchy, of a continental European type, would be a good thing.

If that solution were adopted, it would become more urgent to extend the economic frontiers of the European Economic Community. There would also have to be stricter coordination of the latter's economic and monetary policies which includes the criteria for determining the composition of reserves. Otherwise, there would be an increased tendency to form a dollar area, to which the countries now included in the sterling area would be attracted.

A characteristic feature of the sterling area has been that it allowed multilateral settlement of payments between the member countries. A basic requirement for its proper functioning was, of course, that the members should keep all their reserves in the key currency. This condition is now no longer fulfilled.

Those sterling countries which have a surplus no longer transfer dollars to the central reserves, but keep them; and the deficit countries, even when they have dollars in their reserves, finance their deficit in the first place by using sterling. It follows that the clearing process inside the sterling area cannot be carried out; the surpluses are not reflected in an increase of the Bank of England's reserves, and the deficits reduce those reserves. A similar effect is of course produced by sterling countries' independent decision to change the composition of their own reserves.

In 1965, Italy drew the attention of the authorities responsible for international monetary policy to the need for preventing short-term capital movements, of a kind which might weaken sterling, from being added to the current deficits as they have in fact now been. We contemplated the possibility that sterling balances might have been converted into claims on the International Monetary Fund, which would have eliminated at least a part of the pressure on the sterling exchange. This proposal was partly adopted through the understandings which were reached in 1966 within the framework of the Bank for International Settlements, and which are still in force. On the basis of those understandings, a group of central banks undertook to finance, at short term, a part of the decrease in sterling balances. Provision was made for recourse to the IMF if the need for financing should be prolonged for a greater space of time. These agreements enabled the Bank of England to finance almost the entire outflow of foreign exchange from its reserves during the summer. But even so, and notwithstanding the great effort put forth by way of international cooperation, sterling was devalued in November.

The attitude to be assumed by the EEC governments to a change of the sterling parity had been defined in advance. They had reaffirmed the principle that the responsibility for the decision to defend the parity rested solely with the monetary authorities concerned and declared their readiness to supply the United Kingdom, if so requested, with adequate financial assistance through the IMF. They also made known the limit up to which they would not react if the British authorities, in the exercise of their sovereign right and after consultation within the Fund, should decide to change the pound's parity. In the same connection, we drew attention to the possibility of taking steps to restrict imports, as permitted by the GATT and IMF rules, where there was a deficit on the balance of payments; we also called attention to the serious consequence which would result from a change of the parity unless the sterling balances had been at least partly stabilized. We were convinced that devaluation would certainly be followed by large transfers of funds, the effects of which would have spread from the market for foreign currencies to that for gold.

That is exactly what happened. The crisis of sterling, which had contributed to that of gold, was in its turn aggravated by this latter. Widespread expectation of an increase in the price for gold caused holders of sterling balances to convert these into dollars, and then to exchange the dollars into gold.

The most serious effects were thus concentrated on sterling. That clearly indicates that, although this currency (in which large sums held by non-residents are still employed) continues to perform an important function in the settlement of international transactions, it does not seem able to maintain a reserve currency status comparable to that which it used to have in the past.

In the present world structure based on fixed rates of exchange, the devaluation of sterling further confirms that any change in the parity, especially of the more important currencies, and even though explicit provision is made for it by the IMF Articles of Agreement in the event of fundamental disequilibrium, is nevertheless a dramatic event.

The change of parity cannot be regarded as a miraculous remedy, capable of eliminating the disequilibrium in the foreign accounts. It is often forgotten that release of internal resources in order to obtain an external surplus is practicable only if suitable policies are pursued; the fact is that foreign demand reacts rather slowly to the new parity, whereas price inflation may be immediately stimulated, and is then usually passed on to wages. Enquiries conducted in the United Kingdom indicate that the increase produced by devaluation in the competitive power of British goods is of the order of 6 or 7 per cent, and that this margin may be further narrowed. The energetic measures adopted by the British government in March, and recently supplemented by severe credit restriction, confirm that devalution is not a painless cure.

During the period between the second and third sterling devaluations the growth of the British economy (at an average rate of 3 per cent per annum in real terms) was more than once interrupted by steps taken to restrict domestic demand, these having been rendered necessary by the frequent crises in the balance of payments. It is, of course, true that the short-term debts which the United Kingdom incurred as a result of the second world war imposed a heavy burden; it is also true that the balance of payments has to bear charges resulting from military expenditure, or otherwise connected with the discharge of international responsibilities. There is no doubt, however, that the troubles which have afflicted the British economy since the last war are attributable to more complex causes. Between 1950 and 1966, the proportion of total fixed capital formation to income was appreciably lower than in the principal countries of continental Europe, and the productivity of the investments effected was relatively low.

It seems clear that, especially in modern industrial economies, the pace of development cannot be raised by simply increasing the proportion borne by investments to the gross national product; care must also be taken to ensure that they are productive. The setting of objectives in economic programmes cannot be divorced from the need to allow managements enough latitude in their decisions with regard to possible combinations of production factors; it also appears undeniable that such decisions produce greater effect when they conform to the pressure of market forces. It was these very considerations which led the Soviet Union, and the other countries of Eastern Europe, to embark on the path of economic reforms. But determination of the proportions in which production factors are to be combined must not be hindered by practices which restrict the mobility of those factors.

The problem of how to reshape the monetary relations between the United Kingdom and the rest of the sterling area involves the responsibility of the major industrial countries; but the responsibility for overcoming the difficulties which have for years afflicted the United Kingdom's economy rests exclusively with the British authorities. The heavy task which they have to perform would indeed be eased if the uncertainty about the future relationship between the EEC and the United Kingdom could be removed; the persistent doubt about future British relations with the continent of Europe makes it difficult for British business executives to reach decisions with regard to investment.

The EEC countries have made important contributions to the discussion about reform of the international monetary system. They did so both by urging the need to remove the causes of the disequilibria to which the gold exchange standard is exposed and by pointing out the ways in which those disequilibria could be eliminated. It seems fair to conclude that, despite the divergences of view which have appeared, the elements of substantial agreement are stronger. The views of those people who believe that the new monetary system must be based on the creation of an international currency are not shared by all countries; yet the wealth of knowledge which has been acquired about the working of international money and capital markets has given rise to closer cooperation. While a process of radically reshaping international economic and monetary relations is going on, joint action by the monetary authorities has prevented interruptions in the growth of trade. Probably the very extent to which links have been established between the different economies made it easier to achieve that result; there is also reason to believe that the unity already attained cannot be broken, even in face of the present monetary tensions. The expansion of world trade will continue to be rapid in 1968.

The External Surplus and Internal Investments

Italy's contribution to the working of the international monetary system during the last few years has not been confined to taking part in the discussion about the reform of that system; we have also made some contribution through the management of our foreign assets.

Our balance of payments returned to a state of surplus in April 1964, and in the next four years the surplus totalled 3.7 billion dollars. Roughly one-third of that amount went abroad because our credit institutes were obliged to balance their foreign positions; these changed, as a whole, from a large deficit to a small credit balance. The effect was to put back into the international market a substantial part of the liquidity which had been withdrawn from that market by the balance of payment's surplus. Thanks to the fact that Italian banks preferred to expand their assets rather than to repay liabilities, that helped to broaden the Euro-dollar market. It also enabled our banking system to play a more important role in the wide and highly competitive international market.

The remainder of the surplus amounted to 2.6 billion dollars. It went into Italy's official reserves. Two-fifths of the total was invested in gold, or certificates expressed in terms of gold and resulting from ordinary or special transactions with the IMF, or from transactions carried out within the framework of the General Arrangements to Borrow. The remaining three-fifths were used either to repay short- and long-term debts, chiefly through the repurchase of Italian securities, or to buy medium- and long-term securities issued by non-residents.

Of our official foreign assets at the end of last March, 64 per cent consisted of gold or of assets carrying a gold guarantee, 9 per cent of assets carrying a lira guarantee, and 27 per cent of convertible currencies. The proportion of these to the total official reserves was thus roughly the same as in Belgium and Germany, but far lower than the corresponding proportion in Japan, Sweden and Canada. Among the other countries in the Group of Ten, only France, the Netherlands and Switzerland showed a lower proportion of convertible currencies to their total reserves than did Italy. In our case the convertible currencies, of which 86 per cent are dollars, form a liquid asset adequate to meet the working requirements of a country, like ours, whick does not aim at absolute preservation of its reserves, but admits that a part of these may be absorbed by deficits of the balance of payments if that becomes necessary in order to permit stronger stimulation of productive activity.

The overall surplus of the balance of payments during the four years now considered was the result of a 7.7 billion dollar surplus on current account, and of a 4.0 billion dollar deficit on capital movements; these include credits granted to finance our exports of capital goods.

It would, of course, be possible to pursue a policy of exporting enough capital to offset the whole of the surplus on current account. That policy would be absolutely valid as a means of restoring equilibrium in our international relationships. But from the domestic point of view, the policy must be judged in the light of the economic policy objectives which the state of the country requires. During 1967, as in 1966, a certain outflow of capital resulted from the action taken to prevent the widespread upward tendency of interest rates from propagating to our market, because it would have checked the resumption of investment. Within these limits, the domestic requirements coincided with the needs of international cooperation. One result of the policy so pursued was to halve the overall surplus on the balance of payments as compared with the previous year; the surplus amounted to 324 million, being equal to one-fifth of that on current account.

Once coverage for any cyclical deficits has been ensured, there is a rapid decrease of the social and economic utility which a country obtains from successive increases of its exchange reserves. At the same time, there is a rise of corresponding costs to those members of the international community whose balances of payments are in deficit; and the expansion of world trade is restrained, with adverse effects on the development even of surplus countries.

This raises the problem of determining how the responsible authorities ought to act in order to reduce, or to eliminate, the surplus on current account. Therefore, we must look at the trend of the chief components in our foreign trade, and at the most important of the variables which determine them.

The main feature during the 1950s and the first years of the present decade was a deficit on trade, and a slightly larger surplus on services and transfers combined. The appreciable surpluses on current account were formed mainly as a result of the gradual change from a deficit to a surplus on the balance of trade. Receipts from tourist trade and emigrants' remittances continued to grow, these being consistently the two largest sources of net foreign exchange earnings. The former are one special form of service exports. They mainly depend on changes in the income of those who use such services, as was clearly shown by what took place in 1967, but are also affected by the competition of other countries which offer facilities for tourists. Emigrants' remittances, on the other hand, result from our past history as a country exporting labour.

Our exports of goods grew in 1967 by 8.3 per cent. This rate was lower than the 16.7 per cent achieved in the preceding three years; but it was nevertheless high if account is taken of the near recession in some of the principal countries with which Italy trades most.

One condition for growth of our export trade is an appropriate increase of international demand; another is that our goods shall remain competitive. The first of these conditions cannot be influenced; but the medium term prospects cannot be pessimistic if all governments include economic growth and full employment among their objectives, even in differing orders of priority. Fulfillment of the second condition is assisted by entrepreneurs, by the trade unions, and indeed by the government itself through taxation, plus the provision of incentives and of better public services. The monetary authorities have special responsibility for defending the purchasing power of money. They would fail in their duty if they did not issue a warning that, within our European community, now on the point of abolishing all tariff barriers, it is essential to defend the competitive advantage which our producers have managed to establish.

The external component is particularly important for the Italian economy because our exports are almost exclusively of manufactured goods. The opening of markets has been a constant aim of Italian economic policy since the war; it enables us to extend the limits that our economic development based mainly on manufacturing activity meets on the demand side. Expansion of manufacturing industry implies an increase of employment and of productivity; it also starts a process which automatically sustains itself, and which extends to the tertiary sector. The demand for exports added to the domestic one, induced by the increase of total wages and salaries as well as encouraging producers to avail themselves of economies of scale, further stimulates enterprises' investment, as a result of which more advanced technological methods are introduced.

That is, in brief, the development process which has operated in our country. It is thought necessary that this process shall continue in future years, so that the country may achieve the desired increase of income and of employment, even though this may entail more careful supervision and guidance of the process. These are required in order to prevent the emergence of new disequilibria, while gradually reducing and eliminating those which already exist. It would therefore appear that we must not expect, still less desire, any appreciable reduction of the surplus through the slowing down of our exports.

The annual growth rate of Italian imports had been 4.2 per cent in the period-from 1964 to 1966. It rose to 12.9 per cent in 1967, in which year the national income increased by 5.9 per cent. This indicates that imports chiefly depend on domestic demand.

The relationship indeed operates differently between the various kinds of goods. It operates immediately and constantly in the case of those, like raw materials and foodstuffs, for which the domestic supply is non-existent or highly inelastic. It operates unevenly in the case of manufactured goods, since the extent to which foreign producers satisfy domestic demand will appreciably grow only when, other things being equal, the residual potential domestic supply represented by unused Italian plant capacity is reduced beyond a certain limit. This applies especially to those products, particularly consumer goods, where in terms of quality our productive apparatus affords almost complete coverage of the domestic demand. The same cannot be said with regard to wide categories of capital goods, where our output is complementary to that of other economies, and there is therefore a more immediate relationship between domestic demand and imports.

These considerations make it appear unlikely, in present circumstances, that imports will spontaneously grow by so much more than exports as to absorb the surplus on current account within a short space of time. This suggests that it might be well to issue directives with a view to quickening that process, while at the same time channelling it along lines more in consonance with our economy's long-term objectives.

If expansion of domestic demand is required for the purpose of increasing imports, the encouragement of that demand must not be indiscriminate. Taking into account the links between consumption and investment, encouragement must be directed especially to this latter, both because it is still the weakest component and because its growth will determine the future increase of supply. An economy which hopes to improve or at least maintain its position in a world of rapid economic progress cannot for very long limit investment activity solely to reorganising, or merely modernising, the productive apparatus in its present structure.

In last year's Report, we emphasized that the total amount of productive investments could not be regarded as sufficient, and that there was, in particular, a lack of new enterprise in the most advanced sectors; we also pointed out the need to speed up the creation of adequate economic and social infrastructures. Despite the improvements which took place in the course of 1967, these observations still remain valid.

The inadequacy of total investments is confirmed by their proportion to the gross national income; it is true that this proportion resumed its rise in 1967, after three years of decline, but it was still below the level contemplated in the five-year economic Programme. It must be remembered that the surplus on current account results from the decrease in the propensity to invest; it does not result from an increase of the propensity to save, this having remained during recent years almost unchanged and in line with the Programme's forecasts.

It is to be hoped that the increase of public and private investment will be assisted by the information and consultation procedures initiated within the framework of the Programme. It is also to be hoped that there will be better regulation of the public finances on the side of both revenue and expenditure. The specialisation which has been attained by various countries in the production of capital goods, and the links which have been established between those countries through foreign trade and international investment, have resulted in Italy gaining a place among the large contractors for, and exporters of, complex industrial plants and equipment. From another point of view, that specialisation suggests the possibility of producing more immediate effects with a view to absorbing the external surplus.

At the same time, those effects might accord better with the need to quicken growth by promoting the renewal of equipment in public departments, as well as in public and private research laboratories. This could be done by promoting imports of producer goods which are in a leading position, by reason of the technological advances embodied in them, while production of them by Italy is not at present contemplated.

Such a programme could be executed according to procedures tried out at earlier dates. The Ministry of the Treasury could ask the Italian Exchange Office for the necessary foreign exchange, and could pay for this with the proceeds of security issues taken by the Bank of Italy or by that Office itself. The foreign exchange would be lent to importers by an industrial credit institute on particularly easy terms. The goods should be bought wherever the advantages offered by the most advanced technological methods could be promptly obtained.

Action to expand domestic demand must take account of the limits imposed by the course of prices and of costs. During 1967, as in the two preceding years, prices were maintained at a satisfactorily stable level. It was especially satisfactory in view of the fact that no small part of the increase in prices depended on heavier taxation and higher social insurance charges, plus the raising of controlled tariffs for certain services.

A further point to bear in mind is that, even during the last three years when supply was enough to meet demand, apart from temporary shortage of a few farm products, prices on the whole increased by something between 2 and 3 per cent.

Apart from the delayed effects of previous inflation, the upward tendency was encouraged, as it has been in all Western industrial economies, by the well-known imperfections of the markets for production factors and for products. These imperfections chiefly appear in two interdependent forms. One is the rigidity which, in those industries where productivity rises most, prevents the passing on (through price reductions) of the resulting gains, and the other is the general uniformity of wage and salary increases. If an incomes policy is not accepted, these tend to conform to the increases granted in the most advanced sectors, and they do so independently of differences in the rate at which productivity is advancing.

At the beginning of 1968, the cost of living was also affected by the partial abolition of the rent control. Yet that abolition was needed, with all socially desirable safeguards, as a contribution towards restoring normal conditions in the building sector.

A further point is that the recent increase of social insurance charges, in order to cover partially the pension increases, comes on top of the charges imposed in 1967 and places a further burden on the earning power of enterprises.

In 1965 and 1966, there had been a tendency towards reduction of the labour cost per unit of output; and this had enabled producers to make good, at least in limited degree, the previous three years' considerable rises in costs. Last year that tendency was reversed. In manufacturing industry, costs incurred per employee increased by 9.3 per cent, or appreciably more than in 1966, while the increase of per capita productivity dropped from 9.2 per cent to less than half as much at 4.5 per cent. The increase in costs per employee includes the effect of the defiscalization of social charges; but, even if this had not been included, that increase would still have exceeded the rise of productivity. The considerable slowing down of the rise in this latter does partly reflect the cyclical trend inasmuch as the greatest rises coincide with the initial phases of upswings; but it was also due to the low level of total investment during recent years. The hard work done on internal reorganisation of enterprises enabled them, in part, to make good the slower rate of advance in productivity investment, but evidently that process is now coming up against limits.

It would further appear, so far as some important industries like chemicals and textiles are concerned, that productivity gains during the next few years will be secured mainly by way of concentrating productive units – a process inseparable from new investments.

The increase of labour costs, and the growing pressure of taxation, already slowed down overall profit formation in the course of 1967. On the other hand, the extent to which productive capacities were employed, after having appreciably risen in the first part of the year, declined in its second half. The recovery in investment suffered some slowing down; this appeared, however, to be in course of being overcome in April.

Formation and Use of Saving

In previous Reports, we have indicated one respect in which Italian enterprises are worse off than those in other countries, namely the high proportion of their debts to their equity capital. We pointed out what this meant in terms of limiting capital expenditure and reducing employment.

This year we have looked at the matter from the angle of saving formation. Total saving, as already stated, has grown during recent years in accordance with the indications of the Programme. But, within the total amount, there have been profound changes in the proportions effected by the three major sectors into which the economic system is usually subdivided.

In particular, as a result of developments which occurred chiefly during the four years 1962-65 and were corrected only in part during the next two years, net saving formation was concentrated largely in the households sector, so that the proportions formed by public authorities and by enterprises were lower than in other industrialised countries. At the same time, there was a reduction in the amount of saving which households apply to direct investments.

The separation between centres of saving formation, on the one hand, and centres of decision about investment, on the other, became deeper. The institutional and fiscal conditions which limit both the inclination of companies to issue shares, and that of households to subscribe for them, prevent an adequate flow of equity capital from reaching enterprises, and so compel them to resort to borrowing. This produces two consequences. One is that enterprises ultimately find it more difficult to obtain finance; another is that they are becoming more hesitant about engaging in investments which entail innovation.

The result is that the normal circuit of income (through its formation; its acquisition by households; and its return to productive enterprises, directly through consumption or indirectly through transfer of saving) is not completely closed. The excess of income produced over that used within the country ends up in a transfer of savings to foreign countries. The public authorities provide no adequate intervention, not because the amounts which they decide to spend are insufficient, but because of persistent delays in effecting expenditure, with consequences which were particularly serious in 1967.

Since a high proportion of saving is formed by households and since these, given the present state of our financial system, show marked preference for liquid assets or something similar, our aim is to perfect those mechanism through which households saving are now mostly transferred to users in the public and the private sector.

The fact is that, during 1967, the excess of households' income over their expenditure on consumption and direct investment continued to flow appreciably to the credit institutes. Households' bank deposits increased by 1,872 billion lire. If those effected by the rest of the economy are added, the increase becomes 3,344 billion; the economy's other liquid assets grew by 949 billion. The proportion consisting of notes and coin increased to an extent which conformed to the growth of income.

The demand for funds, on the other hand, continued mainly to take the form of an increase in medium- and long-term debt. It gave rise, in particular, to the issue of public and private fixed-interest securities; the amount issued, after deduction of repayments, was 2,826 billion in 1966 and 2,414 billion in 1967. The amount of these securities directly acquired by the public was 1,258 billion in the former year and 1,242 billion in the latter. The banking system thus continued to work hard, as an intermediary, on reconciling the forms of indebtedness preferred by the users of credit with the types of financial assets preferred by the public.

In 1966, the Bank of Italy initiated a policy of direct intervention in the market for fixed-interest securities. Its object was to reduce the fluctuation of prices and so, in conditions of satisfactory monetary stability, to channel directly into private holdings a higher proportion of those securities than in the past. In its medium-term aspect, the policy is to absorb such securities as exceed the proportion which the public and the banks are prepared to hold; the short-term aspect is to provide bridging facilities to cover the gap between the time when the issuers need the funds and the time when the ultimate subscribers provide them. In the upshot, the net proportion borne by the public's acquisition of long-term securities to the increase of deposits at banks and at the Post Office rose from 22.4 per cent in 1965 to 36.2 per cent in 1966, and to 32.7 per cent in 1967.

On the basis of the public expenditure planned for 1968, and of the requests for financing addressed to the special credit institutes, the gross total amount of fixed interest security issues contemplated for 1968 is about 4,500 billion lire. The net total can be put at 3,200 billion, of which about 2,000 is for the public sector and the rest for the special credit institutes, enterprises, being financed by these latter, account for none of the contemplated issues.

It would not be desirable, however, to increase total issues in 1968 to more than 3,000 billion lire net. On the assumption that income at constant prices increases by between 5 and 6 per cent, while implicit prices (for national income purposes) rise by between 2.5 and 3.0 per cent, and the present central bank policy directed to stabilising security quotations is continued, the public may be expected to take securities totalling about 1,400 billion; notwithstanding the utmost effort by the banks to place them, it does not appear practicable to exceed this limit.

On the assumptions just stated, and assuming that bank deposit rates remain unchanged, deposits at banks ought to grow by something like 3,300 billion. If the assumed growth of income is accompanied by an increase of about 12 per cent in fixed capital formation, the demand for credit in the form of bank lendings should remain stationary at around 2,500 billion lire.

With allowance for the movement of the banks' other assets such as their liquid funds, their obligatory reserves in cash and in Treasury bills, as well as of the liabilities other than deposits, and assuming that credit granted by the Bank of Italy or possibly by foreign lenders will expand by approximately 500 billion, it does not appear possible for the banking system to absorb an amount of fixed-interest securities greater than 1,200 billion, of which one-third would go into the obligatory reserve.

Acquisition of securities by the Bank of Italy cannot be pushed up much above the remaining 400 billion. The monetary base, created by doing so, would form an addition to that which would result from credit directly granted to the banking system, plus approximately a further 400 billion which the public sector is expected to create.

The net outcome of all this would be a monetary base creation to the extent of about 1,300 billion lire. This presupposes that the foreign component, resulting from the balance of payments, would be neutral; any contribution from that source would be offset by changes, in the opposite direction, in the creation due to domestic components. Action by the Bank of Italy to an extent greater than that contemplated would mean an excessive increase of bank liquidity. The result would be to impair control of credit expansion and of the system's liquidity.

Of the 1,300 billion monetary base, the total absorbed by the public may be put at about 800 billion, including, say, 400 billion in the form of notes and coin and the rest in that of deposits on postal account. The other 500 billion would remain at the banks' disposal, a part of which would be used as obligatory reserves, in cash and Treasury bills, while the residue would go to improve their liquidity position.

These forecasts are greatly affected by the course of public expenditure. On the basis of the provisional report by the Ministers of the Budget and of the Treasury for 1968, and with allowance for other subsequent commitments, it has been assumed that the Treasury, the Central Post Office Savings Fund and the autonomous government agencies would incur a cash deficit totalling something between 1,600 and 1,700 billion lire, and the above-mentioned calculations have been made on that basis. It should be remembered, however, that forecasts on this subject are a matter of great difficulty, in particular due to uncertainty about when budget appropriations will be paid out and to the large arrears of expenditure outstanding. According to the provisional results, such arrears expanded in 1967 by about 1,260 billion, half of which represented expenditure on capital account; the amount is reduced to 960 billion lire if loan repayments are excluded. The proportion between the arrears of expenditure outstanding at the end of 1967 and the initial estimates of expenditure for 1968 is about 50 per cent; wide variations in those arrears, besides affecting the supply of monetary base and public securities, may alter the flow of total demand, and may thereby disturb both income formation and the balance of payments.

On another occasion, we mentioned the role, and even emphasised its soundness, assigned in the Programme to public financial policy, understood as a means to promote growth of income, full employment of production factors and monetary stability. But the real situation in which we have to act remains profoundly different from that assumed, and displays contrasting aspects. Thus, on the one hand, provision has been made for expenditure commitments of such size that their full implementation would have raised the total indebtedness of the public sector to levels incompatible with the maintenance of monetary equilibrium; on the other hand, the faster collection of revenue, especially of that allocated for covering new expenditure, and the considerable delay in the effecting of this latter resulted in *de facto* conduct of the public finance during 1967 on such lines as to restrain domestic demand.

The economic system could have stood greater public expenditure; or alternatively, if less had been taken out by taxation, it could have generated proportionately greater expenditure on private account. This would not have given rise to any harmful strains. There would have been no such strains on real resources because, in the face of greater demand, the existing production capacities would have been employed, and the surplus on current account of the balance of payments would have been reduced. Nor would there have been harmful monetary tensions, because the creation of additional liquidity to finance the greater budget deficit would have been offset, at least in part, through smaller creation of liquidity for account of the foreign sector.

Adaptation of the Credit System's Structure to a Growing Economy

We have described some aspects of the complex financial operations by which the Bank of Italy promotes distribution of the credit flows between the various destinations on the lines laid down by the national economic Programme. The success of those operations depends on institutional factors. This is especially so in view of the fact that there may be large transfers of securities from the public to the banking system, and vice versa, while the placing of new issues, suitably spread out in course of time, will be assisted through direct action by the Bank of Italy. Our object is to adapt the banking system's structure to the need for making regulation of the credit flow more effective, and for reducing the cost to the economy of the banks' action as intermediaries.

At the meeting of the Italian Bankers' Association, I referred to the subject of the banks' profit and loss accounts. At that time, we also initiated a discussion about possible improvements to be made in the system; we now propose to resume that discussion on the basis of information obtained during the last few months.

In 1967, the gross income of banks, covered by monetary statistics, as well as of their central credit institutes, reached 2,334 billion lire: 60 per cent came from ordinary lendings in lire and foreign currencies, 16 per cent from capital market operations and the rest from other activities. That income, apart from a proportion which results from relations between banks and with the Bank of Italy, means that a corresponding amount of expenses has to be borne by users of credit and of banking services, that is by producers, by public sector and to a small extent by non-residents. Against that income, the banks had to spend 1,198 billion lire on direct procurement of funds, and 1,067 billion on overheads induding salaries. That left them profit amounting to 69 billion, or 3 per cent of the gross income.

The overheads measure the value of the resources applied to rendering all kinds of banking services. That part of these expenses which could be attributed to the procuring and use of funds, that is after deduction of the part imputable to other banking services, equalled 2.33 per cent of the total funds administered and 3.36 per cent of the ordinary deposits. Comparisons with other countries convey meaning only in so far as institutional differences permit, but they do reveal that the proportions in Italy are among the highest.

Fuller investigation shows that the cost in proportion to the funds administered tends to grow when the size of the institutes becomes smaller; in the case of the smallest institutes it is around 3 per cent. But even among these latter there are some institutes which, with due regard for the special composition of their assets and their liabilities, show management costs which are rather low. These are the institutes where good use is made of offices and of staff. Even among the bigger institutes, on the other hand, while the ratio between funds administered and the number of offices is not sufficiently high, the burden of salaries and other management expenses tends to become excessive in relation to the total business done.

In the light of these considerations, a policy directed to raising the efficiency of the system, while reducing the cost of its services as an intermediary, must aim at merging those smaller institutes where working expenses are too high. It also appears desirable to reorganise the existing network of offices, so that all parts of Italy may have the benefit of banking services adequate to their growth. The gaps which unfortunately still exist in some areas should be filled, while the redundancy in other should be eliminated.

The cost of the banks' action as intermediaries is high, and it tends to grow in line with the rapid expansion of the funds administered. This fact reduces the effectiveness of policies directed to controlling rates of interest, and flows of funds, through regulation of liquidity.

The rates of interest charged for lendings cannot drop below the direct cost of deposits, plus the proportion of overheads attributable to lending operations. This proportion represents an amount greater than the average cost, previously mentioned, the reason being that lending operations are more costly. In respect of the yield on securities held by the banks, and consequently of that on all securities, there is a similar limit; in their case, however, the burden of overheads ought to be appreciably less than the average.

The situation in these respects has, in point of fact, improved. Thus overheads grew by 21 per cent between 1965 and 1967, while there was an increase by 35 per cent in the funds administered. Among the overheads, the labour costs rose in the same period by 17 per cent, but there are to be further increases this year on renewal of the collective contract for bank employees.

It was thus possible for the expansion of the banks' administered funds at a pace faster than that of the national income – a process linked, in its turn, with the size of the monetary base at the disposal of the economic system – to be accompanied by a slight decrease in lendig rates. These rates, for the whole of the banks' lendings in lire and in foreign currencies, dropped from 7.27 per cent in 1965 to 7.12 per cent in 1967. The reduction was in fact hindered by a rise in the direct cost of deposits and other funds, which had risen during the same period from 3.28 to 3.49 per cent.

The course of the rates charged for ordinary lending operations was affected by the spread of subsidised credit. This was very greatly extended, and is continuing to expand at a pace appreciably greater than that of unsubsidised lending. In 1966, out of new credit totalling 569 billion lire granted to industry and for purposes of public works, 52 per cent had the benefit of interest rate subsidies; in 1967 out of new credit so granted to the extent of 886 billion, the proportion subsidised rose to 71 per cent. In the same year the average weighted cost of subsidised borrowing was 4.8 per cent in the case of projects located in Northern and Central Italy, while it was 3.7 per cent for those in the South; the overall average weighted cost was 4.4 per cent, being lower by approximately 4 percentage points than the average market rate.

These trends also exerted a certain effect by way of reducing the degree of specialization from the two opposite directions. Subsidised credit, on the one hand, spread into the area of loans granted to provide working funds; outside the limits of that area, on the other hand, there was some extension of the banks' activity. The only effective limit so far set to the supply of subsidised credit results from the amount of transfers appropriated to the budget for the provision of funds under the various headings.

The rise of deposit rates is partly due to the monetary authorities' action on the market for fixed-interest securities, directed to stabilising the prices quoted for these so as to increase the proportion directly acquired by individuals. The switching of demand towards financial assets of such kinds caused the banks to raise their deposit rates so as to protect their share, as intermediaries, in the total flow of funds. The result was still a large increase both of deposits and of bank lendings, but also an increase in the direct cost of deposits.

It therefore seems desirable to consider what changes we ought to make in the functioning of the banking system; the object would be to increase the latter's ability to make use of its financial resources conform to the expansive and restrictive impulses emanating from the monetary authorities.

The fact is that, in the absence of any true money market on which credit instruments can be bought and sold at an effectively variable price, our credit system is able to exert a real restrictive effect; but it appears less suited for transmitting stimulative action by activating the liquidity put into the system, and by an accompanying reduction of interest rates.

Among the arrangements which we should propose to revise, with a view to achieving the objects mentioned, the first will be the obligatory reserve. The admitting of mortgage bonds and other securities for inclusion in the obligatory reserve has indeed already changed, on the one hand, the total income obtained from that reserve by the banks, and, on the other hand, the extent of its effectiveness as a means for quantitative control of credit. We feel that further changes in the obligatory reserve ought to be towards greater uniformity of the obligation for all the registered credit institutes. With the object of making the composition of the existing reserves more homogeneous, authority could also be given for the replacement of cash or Treasury bills, now included in the reserves, by securities which yield a higher return and which would be taken from the Bank of Italy's holding.

We feel that, apart from this revision, the government should be given the task of deciding whether and how to achieve effective separation between the yield on Treasury bills put into the obligatory reserve, and that on the Treasury bills in which a part of the banks' available liquid funds is invested. At the same time the government should decide whether and how the official rate of discount on stockpiling bills is to be separated from that on ordinary bills. By this means, it would be possible to maintain at a constant level both the overall return on the banks' reserves and the cost, for the government, of old stockpiling bills operations. It would further be possible to restore to changes of the discount rate the function of supporting the liquidity policy which the monetary authorities intend to pursue, as well as that of influencing bank interest rates in conformity with the Bank of Italy's open-market operations in securities.

With these objects in view, we do not, on the other hand, agree with the suggestion that there is any need to concentrate at the Bank of Italy that part of deposits, increasingly large, which results from excess liquidity held by public sector and similar entities, nor that part which originates within the credit system and takes the form of interbank balances. Both types of funds must remain within the banking system; they must contribute to the supply of funds, and the demand for them, and hence to the formation of interest rates. If these funds were taken away from the banks, that would reduce the possibility of creating an efficient money market. The immediate effect would be to induce disequilibria in certain institutes, or groups of institutes, and so compel the Bank of Italy to take compensatory action.

The execution of the programme which we have just described, both the part providing for merger of banks and for territorial redistribution of their offices, and the part which relates to functional improvements in the system, requires adequate preparatory work. That work is now being done by the Bank of Italy. The main object is to provide better information, not only for the supervisory authorities but also for the credit institutes themselves, about the structure of the latter's expenses and income and about the terms which they apply to their customers. This programme must be executed by degrees along the lines laid down. Every care must be taken to avoid disturbing the continuous working of the system; steps must also be taken to create new monetary and financial assets on a scale adequate to the needs of economic development. With this objective we shall seek the co-operation of the banks, and of their associations, because the higher the degree of consensus previously secured, the more fruitful the results will be.

In a previous Report, we urged the need to maintain the dividing line between institutes providing credit at short and at long term. We emphazised that it was desirable to preserve a system in which the transfer of savings, from the households which produce them to the enterprises which invest them, should take place through the banks' acquiring securities of the special credit institutes, which make a pool of selected risks and obtain adequate security for the credits they grant. Experience confirms that such an arrangement has kept the credit institutes sufficiently protected against events which have affected some sectors of our economy. We must, however, say that we are concerned about some more serious setbacks, for instance in the textile industry. We must again ask ourselves why the general tendency to extend subsidised credit has stopped short of that industry, which in our country is one of those most distressed and most in need of large-scale reorganisation.

In the course of this Report, we have described the principles which guided the control of liquidity during 1967; having set as a target the stabilisation of prices for long-term securities, we left it to the market to obtain all the liquidity for which it felt a need, obtaining it on the terms laid down and through the channel selected by the central bank. The *de facto* reduction which took place during the year in the banks' obligatory reserve ratio, because the fact that they exercised their option to deposit securities, correspondingly reduced their need for monetary base. For that reason, among others, the decrease in the contribution by the Treasury and the balance of payments to the creation of monetary base required only partial offsetting through central bank action.

In these concluding remarks, we have said that we propose in 1968 to continue placing at the economy's disposal enough liquidity to ensure that the contemplated issues of fixed-interest securities can be absorbed at stable interest rates. We also stated that this is compatible with growth of bank lendings on a scale sufficient to finance production which will make it possible for income to grow, in conditions of satisfactory price stability, at the average long-term rate.

We do not think it possible to expand total credit to an extent greater than that just indicated, because this would require the Bank of Italy to bring about a reduction of the long-term interest rate. While the pull exerted by higher foreign interest rates caused a large outflow of capital in 1967, any widening of the differential would cause our savers to make even greater use of opportunities for remunerative employment of funds abroad.

We must again point out that investments in foreign securities are effected not only on grounds of yield, but also because holders find it desirable to diversify their portfolios. Although our capital market is one of the largest in Europe, so far as size is concerned, it is poor both in institutes and in instruments; it therefore offers only a limited choice to people who wish to effect financial investments.

The effects produced by the lack of variety in securities are aggravated by the system of taxing both company earnings and the part distributed in the form of dividends. The result is to increase the attraction exerted on Italian savings by capital markets which offer securities that embody features more pleasing to our investors. In the end, the Italian economy suffers seriously from this. There may be a further damaging effect on people who entrust their savings to foreign mutual investment funds; in many cases, the composition of these funds' portfolios, and the quality of the securities contained in them, are far from conforming to the principles of correct management. Italian savers are in this way deprived of protection, financing institutes are deprived of resources, and the productive system as a whole is deprived of the opportunity to offer greater employment; yet Italian capital helps to create such opportunities in foreign countries where a part of our labour force is employed.

Compulsion will not serve to prevent capital from flowing out to foreign countries. If we believe in the need to maintain communicating links between economies, we must harmonise the legislation about securities and the rules about taxing investment income; we must broaden our market, both by increasing the number of companies whose securities are quoted on the stock exchange and by setting up the mutual investment funds to which we have repeatedly referred. We feel that the great public and private enterprises which enjoy subsidised credit should be required to offer a proportion of their shares for public subscription, and to apply for quotation of those shares on the stock exchange. This would not only widen the choice for those savers who wish to buy shares. It would also extend the range of people who participate in profits and risks inherent in the management of companies. In conformity with the spirit of the proposed legislation about stock exchange and companies it would also create the conditions required for the public to form sounder views.

Besides these amendments, we have indicated others which are within the scope of our more direct responsibility. These must in the long run benefit our economy, which is, on the whole, in a satisfactory state both internally and externally. According to our estimates, the total foreign assets held by the public and private sectors at the end of 1967 amounted to 16.1 billion dollars, and the corresponding liabilities to 9.7 billion dollars. The net surplus was thus 6.4 billion dollars, of which 5.8 billion dollars were liquid assets. Despite Italy's present favourable external position, the policy which we pursued during 1967 can be continued only within limits. This is in so far as the condition of international markets, the course of domestic production, our internal monetary trends and the state of our external accounts make it possible.

Thanks to the continuous improvement in techniques of control the central bank's room for manoeuvre is far from little. But, while the process of integrating Italy into the international economy makes such action more necessary, it also sets limits which cannot be overstepped without interrupting the process. Our most recent action has already run into obstacles greater than in 1967; yet we believe that the difficulties ahead of us can still be surmounted. This however is on condition that, in preparing the necessary reforms, one can avoid the fear of unforeseeable changes in institutes and taxation, or of interruptions in the programmed course of economic policy.

This very day, the special drawing rights, and other amendments to certain provisions in the Bretton Woods agreements, will be approved. Italy, by promptly adhering, has given further proof of its zeal in the search for methods likely to safeguard the principles and the institutes of international cooperation, which powerfully contributed towards opening up new prospects, and promoting post-war economic reconstruction.

We must at the same time realise that, with the passing of time, cracks in the harmonious edifice erected at Bretton Woods have increased in number. Suggestions are being made for undertaking, in what appeared to be the cornerstones of that edifice, changes which are not in all cases reasonable. Some of them would indeed render doubtful the stability of the structures then created. In marked contrast to their weakening, however, is the solidarity which in fact exists between the various countries at the level of enterprises, of financial groups, of living cultural forces and of technology. This interlocking process reduces the risk that we may have to travel backwards along the road of our former advance. I refer to the danger that the world may again experience that restrictive policy which led to the fragmentation of economies, to inclinations for autarchy, and hence to enfeebling of the very idea that an integrated international community could be achieved. Nowadays, it must be admitted, even the strongest critics of the existing system hold views from which it is indeed possible to dissent, but which in every case assume the peaceful co-existence of the nations on terms of equality.

Not only, therefore, do the conditions and results of productive activity appear generally reassuring but new forces and energies are in addition being released, although not indeed always in desirable forms. They are generated through the manifold and increasingly close relations between different countries finding their ultimate, life-giving elements in man's capacity for invention and adaptation, as well as in the tenacity of mankind.

These are the facts and the considerations which led me, on the aftermath of the devaluation of sterling while persisting difficulties beset the dollar, to proclaim my confidence in the flexibility and strength of the Italian economy. That, too, has a fund of new energy, constantly flowing in an abundant stream; at the same time it benefits from international cooperation, which continues and grows stronger.

Thanks to the priority which will be assigned to modernising the administrative machinery which is a prerequisite for timely coordination and guidance by the public authorities, Italy can confidently apply its powers to the tasks now essential for its progress.