

## Concluding Remarks for 1968

In all Western industrial countries during 1968 the economy achieved a satisfactory rate of growth. For some years now, such growth has been impelled by the international integration of markets; this has afforded to a growing number of people greater possibilities of choice, both at home and abroad, for their investment, their consumption and their decisions concerning the places at which they are to work, to study, or to spend their leisure time. The great increase of the area open for the free exercise of options by business men, and the high degree of interdependence between economies, have not, however, been accompanied by an adequate reduction of divergencies in the economic policies pursued in the various countries. The differences between these policies are due to the fact that the countries' institutional frameworks conform more slowly with the changes required by the successful linking of markets, or to particularistic views and attitudes.

This has resulted in contrasts which have had a major impact on the international monetary system. The latter, having been protected during the year considered against speculative pressures on gold by the introduction of the two-tier market, was enabled to cope with emergencies through prompt decisions by the central banks. Its adaptability, which materialised chiefly in the channelling of additional credits to the places where they were most urgently needed, made it possible to preserve from serious impairments the ties between the various economies.

But over and above the solutions which made it possible to overcome sudden crises, the question of more radical changes in the international monetary system designed to adapt it more closely to the evolution of the world economy has been debated for some time now.

The working of the present mechanism directly depends on the size and distribution of monetary reserves, on the degree of international cooperation and on the nature of the disequilibria; it is

adversely affected by divergencies between national policies of demand management, as well as between trends in unit costs of production, these being frequently less favourable in countries where the increase of productivity is slow.

Over the years, the action of the above-mentioned variables has generated tensions in the system. Two different – but not necessarily mutually exclusive – ways have been proposed for eliminating these tensions: by gradually making fixed exchange rates less rigid, and by expanding international liquidity independently of the US deficit.

Therefore, it is appropriate to examine the current debate about the exchange system, and then consider the effects of the position of the dollar on international monetary and financial relations.

### Fixed and Flexible Rates of Exchange, and Compromise Solutions

No discussion about the alternative between fixed and flexible rates of exchange can disregard the useful function which the former have performed in promoting the restoration of orderly currency relationships in the world in accordance with the principles deliberately embodied in the Bretton Woods agreements.

Whereas, in this connection, the views of the economists are usually contrasted with those of the bankers, it should not be forgotten that authoritative representatives of the former have contributed substantially to the decisions whereby the international monetary system, after World War II, was based on the principle of fixed rates of exchange. The period which has since elapsed did, however, provide further experience. One factor of special importance for the problem under consideration was, for instance, the large transfers of funds between the different economies following the extension of currency convertibility. Another was the degree of inflation accepted by countries that are able, by virtue of their considerable economic importance, to produce extensive effects on a large part of the international community, and especially on the major industrialised countries.

The opponents of fixed exchange rates readily admit that, given a great mobility of the production factors, such a mechanism affords the same advantages on the international plane as a single currency

does at the domestic level. But they point to the present rigidity of prices and costs to complain that, in the event of external imbalances, the adjustment is effected either through deflation or through discriminatory quantitative restrictions on imports. In their view, a fluctuating rate of exchange is preferable to the former alternative, because it entails smaller social costs, and to the latter because it does not hinder the growth of trade. They argue that, while restriction of trade in fact concentrates the entire adjustment on certain products, and in certain geographical directions alone, a flexible exchange rate distributes the effects at the margin over the entire range of imports and exports as well as over all the countries with which trade is conducted.

But there is no denying that the introduction of flexible exchange rates does create uncertainty, and that the elimination of this uncertainty through forward exchange contracts does increase the cost of foreign transactions. The problem of such uncertainty is, in its turn, directly linked with speculators' ability to act in a stabilising sense. This is especially so when there are unexpected changes in the overall level of prices and costs, or in any other variable which may affect the balance of payments. It does not seem unreasonable to assume that, since speculators have to form a view about what the fiscal and monetary authorities' policies would be in the new conditions, their behaviour may produce a destabilising effect. Nor is it possible to rule out a snowballing process, in the sense that the perverse conduct of speculators may react on the decisions of the authorities responsible for economic policy. The initial effects of that conduct may indeed press or compel the authorities to adopt the very solutions – otherwise avoidable – that speculators had meant to cover against or to profit from.

Other arguments for and against fixed rates of exchange are even less general in nature; they base the preference for one system or the other on the conditions in which the economy happens to be at a given time. It is said, for example, that in dealing with an external imbalance due to cyclical factors, a flexible exchange rate mechanism entails heavier social costs, because it requires a country to balance its resources and their uses in the short run. Because the process of reallocation is necessarily slow and difficult, a fixed exchange rate system which allows to cover the external deficits by drawing on reserves, and to rebuild the latter during the favourable phase of the cycle, will avoid useless reconversions of production plants.

If a deficit on the balance of payments is due to a rise of domestic costs, the attitude taken by most central banks, but which only a few economists are prepared to endorse, is that the rigidity of the exchange rate may help to keep prices stable and to counteract inflationary tendencies; to its opponents, on the other hand, far from checking wage inflation, fixed rates of exchange appear to be a source of deflationary policies. Should cost inflation become irreversible, and the disequilibrium structural in character, the conclusions would be different; but even in that case, rather than let exchange rate fluctuations equate the country's internal and external degrees of competitiveness, a more timely use of parity variations would appear preferable.

When a surplus in the balance of payments is due to excess foreign demand because of inflationary tensions outside the country where domestic stability is instead maintained, the prevailing opinion is that a fluctuating rate of exchange would be more suitable than a fixed one. With fixed rates, the adjustment ought to take place through expansion of consumption and investment and therefore, given the continued pressure of external demand, through changes in the national income as well as in the level of wages and prices, changes which would necessarily entail the abandonment of internal stability. With flexible rates, on the other hand, the impact of foreign demand would be mitigated by the appreciation of the national currency. The same objectives could be attained by frequent, and possibly automatic, variations of the parity.

From a comparison of the opposing arguments it would appear that stability of exchange rates, i.e. the absence of violent fluctuations, together with prompter recognition of the possible need for parity variations, constitute essential requisites for the proper working of the international economic system. While the theoretical arguments in favour of flexible exchange rates do not seem to prevail at all, it is not difficult to state arguments, even though they be of a non-analytical character, in favour of maintaining the present regime. On the one hand, a rigid rate of exchange unquestionably ensures the advantages of a single monetary system; on the other hand, it is undeniable that the conditions for its proper functioning are fulfilled only in part; but it is probable that the existence of fixed exchange rates, and the political determination to maintain the system based on these, are sufficient to create conditions suitable for a continuance of that system. As a result of the fixed exchange rate system, every

country is able, through its economic policy, to communicate to the other countries inflationary or deflationary stresses proportionate to the imbalances in its foreign trade, as to its capacity for accumulating or losing reserves; similarly, every country is exposed to the impulses which originate from the others. In present day conditions, this interplay leads, as a rule, to the acceptance of a moderate degree of inflation. This exchange rate system is thus the one most likely to bring about passive coordination of economic policies, which represents a start towards the active coordination which may follow at a subsequent stage of integration. If this is so, then fixed rates cannot be renounced by any community of states with integrated economies, or desirous of integrating them. That explains why those who believe in the possibility of fully realising the European Common Market favour abolishing the margins of fluctuation between the currencies in the area, even if all the conditions justifying such abolition – and including, for example, effective coordination of economic policies – have not yet been fulfilled.

The adjustment of the parity in the event of fundamental disequilibrium, and also the widening of the band within which exchange rates can fluctuate, have been the subject of proposals for amendment. In the event of fundamental disequilibrium it is proposed that sudden adaptation, often of considerable extent, should be replaced by a series of small devaluations or revaluations at weekly, monthly or quarterly intervals; one advantage presented by the crawling-peg system, as compared with the present system, is that it would not entail any decision regarding the size of the total change, but would leave to time and to the market the task of determining it or of indicating it to the authorities.

One characteristic of this mechanism is that it can wipe out, through appropriate differentials in short-term interest rates, the incentive for speculators to transfer their funds out of a currency which is depreciating into the currency which is appreciating. In order that the said differentials may be kept within the limits permitted by operational possibilities, the maximum variation of the parity in the course of a year ought not to be far from 2 per cent. This means that the adjustment process must necessarily become slow; the business sector's confidence that the rate of exchange cannot be modified by more than is contemplated by the mechanism would depend on the existence of large monetary reserves. The system is not entirely safe against the danger of competing devaluations and retali-

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ations. The authorities can intervene defensively or aggressively, within the margins of fluctuation, modifying the market's behaviour through which the parity changes are determined. These changes, however, would be no longer open to objection if the principle were established that parity variations, which are moderate and therefore tolerable, do not call for retaliation, even if they are repeated. This means that, without adequate cooperation, not only the problem of increasing international liquidity, but also that of improving the adjustment mechanism, will be impossible to solve. The reequilibration processes would, for example, be greatly facilitated by understandings, at the international level, about medium-term targets of economic policy; for each of the main industrial countries, it would be necessary to decide whether the current account should be balanced or in surplus, what the size should be of any surpluses in proportion to national income, and what direction would be preferable for capital flows. A greater degree of harmonisation is necessary, within the European Economic Community itself, if one considers that the rates of inflation within it are still far from uniform; consumer prices during the last three years have increased in differing degree, moderate in Germany and Italy but rather sustained in France, Belgium and the Netherlands, ranging on an annual basis from a minimum of 2 per cent in the first of these countries to a maximum of over 4 per cent in the last. The rate of price increase acceptable to public opinion also differs considerably between the five countries.

The experience gained in 1968 and in the current year confirms that the cyclical wave coming from the United States has repercussions in Europe which are complicated by the diversity of national economic trends and by differences between the policies pursued with a view to countering those trends. It is, finally, the imprint of the big united country beyond the Atlantic which predominates, and this tends to create in Europe a feeling of impaired national identity; this applies both to individual countries and groupings of countries. Another result is a certain predisposition to loosening the links between the two sides of the Atlantic.

Inside the East European countries, on the other hand, the interaction between economic development and international trade is coming to be more evidently recognised; in particular, the smaller countries have attained a stage of development which they would find hard to improve on unless the size of their markets is increased.

Within those economies, moreover, the conviction is increasingly gaining ground that international trade and its expansion depend on multilateral payment systems. All this evidence appears to suggest that the time is approaching when it will be appropriate to reconsider the whole structure of trade, and the framework within which this is conducted, with a view to extending the present institutions to include a wider circle of countries.

### **The United States' Balance of Payments, the Euro-Dollar Market and Interest Rates**

The United States' balance of payments, notwithstanding the almost complete disappearance of the trade surplus, has shown, on a liquidity basis, the first small surplus for twelve years. This is undoubtedly the salient feature of recent American trends, especially when it is borne in mind that last year the United States exported capital to the extent of 7 billion dollars, and effected unilateral transfers to that of 3 billion dollars, putting funds into international circulation to the total amount of 10 billion dollars. As the surplus on goods, services and income from abroad was only 2 billion dollars, equilibrium was restored by the considerable inflow of long-term capital, especially from Europe, induced both by higher yields and by anxieties of a political or fiscal nature; the said inflow mostly took the form of subscribing for shares, for ordinary and convertible bonds, and for units of mutual funds which invest their resources in American securities. Ultimately, therefore, the real resources for the benefit of countries to which the United States lent money, or granted aid, were provided by the rest of the world. They were in fact mainly supplied by three countries: Germany, Italy and Japan, which together contributed about 7 billion dollars.

In last year's Report, we said that the United States ought to have achieved surpluses on trade and services of a size sufficient to offset financial transfers in the form of government expenditure as well as of foreign aid and investments abroad. We added that the extent of the improvement needed on foreign transactions would seem to require that the relevant adjustment process should be spread over a rather long period of time; otherwise it would have resulted in



effects damaging to the maintenance of continued development in other countries. In point of fact, the methods by which, and the pace at which, the balance of payments was squared not only had a great impact on the European monetary and financial markets, but also led to indirect effects, as they induced the majority of European monetary authorities to adopt defensive measures.

During the second half of 1968, as the Federal Reserve System's policy became more restrictive, rates of interest in the United States showed exceptionally large increases. In spite of this, the demand for funds remained unabated; American enterprises sought to remedy the growing scarcity of credit either by direct recourse to foreign markets or by drawing on those credit lines which, in the light of the experience gained during 1966, they had previously obtained from banks.

Part of the resources required for financing investments inside the United States were raised through the issue of convertible bonds on European markets, where the funds needed by American companies' foreign affiliates were also obtained in accordance with the directives issued by the American authorities at the beginning of 1968. Since domestic yields on primary bonds had risen above 7 per cent, such companies were able to cover their marginal requirements on the European markets, where they offered to pay a higher price for the money. Through the Euro-bond market the pressure on medium and long-term rates spread to Europe, whence it again bounced back across the Atlantic.

Through activation of credit lines, plus the demand for new facilities, the pressure exerted by American enterprises in search of funds was concentrated on the large banks which operate in the money market. These banks could have sold part of their security holdings in order to obtain the funds required to meet the producers' growing demand for credit; if they had done so on a large scale, however, not only would they have suffered losses on capital account because of the fall in security prices, but they would not in any case have avoided a reduction in their share of intermediation. When the rates tend to rise, the existence of a maximum limit on the rate paid for deposits prevents the banks from keeping those deposits which are most sensitive to the rate of interest.

It happened in this phase of monetary restriction, just as it had in previous such phases, that the market for certificates of deposit contracted, with the result that funds were drained away from the

large banks, just when the demand for loans was strongest. In an effort to prevent the withdrawal of larger deposits, banks experimented with the issue of certificates of participation, attesting that their customers had directly financed borrowing enterprises; while from the formal point of view such certificates are not in the nature of deposits, and are therefore not subject to the restraints applying to these, in fact they assure their holders the same degree of security and liquidity as that afforded by deposits with banks.

Faced with the persistent loss of deposits due to the rise in rates, the major American banks reacted by shifting their competition for funds outside the United States, thus avoiding Federal Reserve regulations. By this means, each bank was able not only to maintain, but actually to increase its share of intermediation by offering higher interest rates. This explains why the strongest push towards higher rates of interest on the Euro-market is attributable to the behaviour of the major American banks with branches in London; these branches transferred to their respective American parent banks cash to the amount of 2.7 billion dollars in 1968, and to an equal amount in the first three months of 1969. The rates of interest which they paid actually rose above 8 per cent, the excess cost by comparison with procurement of funds on the home market being only between 1 and 1.5 percentage points.

The size of the United States' short-term dollar liabilities to non-residents, including Euro-dollar market liabilities, varies according to the outcome of the balance of payments, on liquidity basis, and to the transactions effected by central banks with the United States Treasury and with the Federal Reserve. Commercial banks' operations do not affect the total amount of dollars available, but do affect the distribution of those dollars between the individual banks and between the various types of investment. The first consequence of absorbing Euro-dollars for use in the United States is to transfer non-residents' deposits from the American banks which have no foreign branches to those which have branches in London. The American banks' willingness to pay higher interest rates causes the commercial banks, in countries where domestic-currency liquidity is high, to convert increasingly large amounts into foreign currency for deposit with the American banks; the effect is to transfer dollars from the accounts of the central banks to those of the commercial banks, and from investment in United States government securities into bank deposits. In the last resort it may happen that the central banks will

with fear that this or that currency might become unconvertible. Since confidence grows in proportion to the size of a country's monetary reserves, there have been times when capital flowed towards countries with the highest reserves. The balance-of-payments deficits have indeed become an inverse function of the official reserves. The central banks short of liquid foreign assets therefore tried to protect their position by raising rates of interest, but in many cases their defensive action was frustrated by the violent waves of speculation.

Awareness of the magnitude attained by international transfers of funds prompted by political fears, and awareness that no country's reserves are sufficient when such transfers occur, constitute the basic reason why we suggested that short-term funds wandering because of speculative factors should be re-cycled and so contribute towards rebuilding the reserves impoverished by such transfers. We put this idea forward in November 1968, at the meeting of the Group of Ten in Bonn. We did so because we felt some apprehension that sudden crises, like the one which had caused that conference to be unexpectedly convened, might occur again. We felt that in this case it would be preferable to prepare, sufficiently in advance, a mechanism for the re-cycling of funds. We wish to repeat that any agreements on the re-cycling of funds would contribute only towards mitigating the consequences of capital transfers made in anticipation of parity changes. Such agreements cannot reduce the urgent need for decisions aimed at removing the causes of the said expectation. Suggestions from authoritative quarters have resulted in a better formulation of the proposal (which is still capable of further improvement), but divergent views on definitions have so far prevented a solution being agreed upon.

Then came the crisis in the second week of May. The Euro-dollar market was violently disturbed, and the central banks of the United Kingdom, France, Belgium and the Netherlands sold on the market billions of dollars which were transferred to the Bundesbank's accounts. The system of reciprocal aid did reduce the loss of reserves suffered by the countries which were in the greatest difficulty; we ourselves, although we suffered losses of reserves, did our part in providing such aid according to the understandings reached in Bonn.

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have to replenish their liquid funds by engaging in swap transactions with the Federal Reserve System.

The attraction of Euro-dollars into the United States reduces the gross size of the Euro-market, because the number of intermediate transfers between non-American banks is cut down. The net size of this market shrinks when United States residents withdraw funds, which they have deposited with European banks, in order to employ them in their own country. In so far as this happens, the United States' balance of payments improves, and competition on the market for Euro-dollars becomes keener.

The effects produced by the rise of rates on this market spread inside the individual European markets. Those banks which had suffered withdrawals of funds by customers, who wished to channel their liquid resources either into the Euro-dollar market or into the United States, raised the rates of interest paid on deposits. This especially happened in the Netherlands and Belgium, that is, in countries where the cross-flow of international funds is strongest. Since the banks with a balanced or deficit foreign position had to meet the excess of withdrawals over deposits by drawing on the funds held by their respective central banks, the consequence was that some of the latter found it necessary to raise their discount rates. Others, like the Bank of Italy, directed the banks to balance their surplus foreign position.

In an attempt to reduce the sharpness of competition between American banks on the market for Euro-dollars, and hence the repercussions on individual European money markets, it has been suggested to the Federal Reserve that the latter should extend to funds transferred from the American banks' foreign branches the same provisions as those which apply to deposits, such as the ceiling on the rate of interest and the obligatory reserves.

The introduction of a moderate reserve ratio, however, would in all probability produce an effect opposite to that desired. Since the big banks feel more strongly the effect of a restrictive credit policy, the need to procure additional funds would maintain almost undiminished the incentive for them to raise such funds on the Euro-dollar market. The consequence would be similar to a reduction in the size of that market, inasmuch as the rates of interest there would tend further to rise. Consequently, any credit restrictions applied to American banks would ultimately affect both enterprises resident in the United States and non-residents as well.

In the event of the imposition of a ceiling on interest rates or of a very high percentage of obligatory reserves – even 100 per cent – the American banks might evade such measure, for instance by extending the issue of participation certificates from the home to the foreign market. The market for Euro-dollars would thus again prove a vehicle of monetary tensions.

The question, therefore, is in what direction American rates of interest will move in the near future. The present state of inflation of the American economy, and the persistently heavy demand for credit, have caused the Federal Reserve System to raise the banks' obligatory reserve percentage and also to raise its own discount rate, bringing this up to the record level of 6 per cent. The prevailing opinion is that rates of interest will remain very high, although the possibility is not ruled out that they may decline during the second half of the year. A factor which ought to contribute towards this result would be the Treasury surplus, anticipated on the assumption that the United States government's tax proposals are approved.

In these circumstances the question arises whether countries like Germany and Italy, where the authorities have pursued a policy of keeping interest rates stable at the cost of capital exports, can continue to defend their present interest rate structure. We do not believe it possible in the long run to accept the kind of equilibrium in our external accounts that makes Italy a major supplier of capital to the rest of the world. Under a system of fixed exchange rates and relatively free capital movements, on the other hand, it is difficult to oppose the tendency towards an international levelling of interest rates. It would therefore seem that the answer must be found in closer international cooperation as well as better coordination of objectives. If there is no such harmonization, interest rate escalation becomes inevitable, with effects which are just as harmful as those resulting from an exchange rate war.

### **The International Monetary System and Economic Integration**

The tensions caused by the American attraction of funds were accompanied, in 1968, by others endogenous to Europe. Transfers of short-term funds were increased by fear of parity changes, coupled

with fear that this or that currency might become unconvertible. Since confidence grows in proportion to the size of a country's monetary reserves, there have been times when capital flowed towards countries with the highest reserves. The balance-of-payments deficits have indeed become an inverse function of the official reserves. The central banks short of liquid foreign assets therefore tried to protect their position by raising rates of interest, but in many cases their defensive action was frustrated by the violent waves of speculation.

Awareness of the magnitude attained by international transfers of funds prompted by political fears, and awareness that no country's reserves are sufficient when such transfers occur, constitute the basic reason why we suggested that short-term funds wandering because of speculative factors should be re-cycled and so contribute towards rebuilding the reserves impoverished by such transfers. We put this idea forward in November 1968, at the meeting of the Group of Ten in Bonn. We did so because we felt some apprehension that sudden crises, like the one which had caused that conference to be unexpectedly convened, might occur again. We felt that in this case it would be preferable to prepare, sufficiently in advance, a mechanism for the re-cycling of funds. We wish to repeat that any agreements on the re-cycling of funds would contribute only towards mitigating the consequences of capital transfers made in anticipation of parity changes. Such agreements cannot reduce the urgent need for decisions aimed at removing the causes of the said expectation. Suggestions from authoritative quarters have resulted in a better formulation of the proposal (which is still capable of further improvement), but divergent views on definitions have so far prevented a solution being agreed upon.

Then came the crisis in the second week of May. The Euro-dollar market was violently disturbed, and the central banks of the United Kingdom, France, Belgium and the Netherlands sold on the market billions of dollars which were transferred to the Bundesbank's accounts. The system of reciprocal aid did reduce the loss of reserves suffered by the countries which were in the greatest difficulty; we ourselves, although we suffered losses of reserves, did our part in providing such aid according to the understandings reached in Bonn.

The rush to incur debt in the currencies most exposed to speculative attack caused a spectacular rise in interest rates. On some days, these reached 39 per cent on an annual basis. The one-month

forward premium of the lira on the dollar reached 6.72 per cent at the end of the week. One reason was that the Italian banks, wishing to acquire marks, bought large amounts of spot dollars and resold them forward against lire; another was the belief, entertained in some quarters, that the Italian currency would also be revalued.

In that connection, if a general realignment of parities were envisaged, Italy's attitude could only be that which has more than once been stated by the Minister of the Treasury. A condition for maintaining a high rate of growth in Italy is an increase of international trade, both exports and imports, proportionately greater than that of income. Since the per capita income level is lower in Italy than in the majority of Western industrialized countries, reduction of the existing gap requires that Italy's foreign trade shall increase by more than theirs. It follows that Italy could not accept any solution which would impair our ability to compete on international markets.

If the United States continue to export capital and make unilateral transfers to the rest of the world to an extent greatly exceeding their surplus on goods and services, including income from abroad, it would be desirable to reach multilateral understandings on the most appropriate ways of financing the deficit. If settlements were made by increasing short-term liabilities towards the rest of the world, since these contribute to create international liquidity, it would cause increases in this liquidity beyond the control of the international community; if it were made by long-term capital imports, it would produce effects damaging to financial markets. In both cases, the equilibrium of the system would require other countries to export considerable amounts of real resources. At any rate, should the American deficit persist, it would be preferable that part of it should be financed with the intervention of the International Monetary Fund, and through short-term credit, or by a combination of both.

The proper functioning of the international monetary system requires that the United States' and the United Kingdom's balances of payments be restored to equilibrium. That process, if it is to be carried out without dangerous deflationary developments, calls for immediate activation of the special drawing rights. It is desirable that the chief industrial countries should unite in reaching a decision on the subject this year. The amount to be activated should take into account not only the reduction of the free world's monetary gold stock, but also the need to offset the destruction of liquidity due to the major industrial countries' adjustment process. It should further

allow for the need gradually to replace the dollar in its function as a component of the industrial countries' official reserves.

A further improvement of the system could be the introduction of crawling-pegs, as previously mentioned. Nor should one rule out a greater flexibility of exchange rates between the two great monetary areas, the United States and Europe. This would be justified by the fact that the proportion of the external component to income in Europe would become, if not so small as it is in the United States, small enough to minimize the disadvantages of the system. Failing agreement on a solution, a system of flexible exchange rates as between the United States dollar and the rest of the world's currencies could result from a unilateral decision. But this would mean a halt in the process of cooperation, from which the Western world's economic development has derived great benefit, and a return to isolationistic policies, entailing unpredictable consequences.

In Europe, any such system, if not preceded by agreements effectively increasing the degree of coordination between the economies of the member countries of the European Economic Community, might result in the disintegration of the latter. It would, moreover, become essential to seek solutions such as would permit the United Kingdom to join the Community; otherwise, the effect would be to push that country towards the American area, even if this were not considered a desirable alternative.

We feel that this statement of the problems which now beset the international monetary system must not fail to mention a certain mental attitude, which transcends all debates of a technical character, and attacks the validity of the open economy which that system has helped to establish and strengthen.

The high degree of integration between economies may cause tensions and disequilibria, and has in fact caused them during recent years. There are consequently some critics who contrast the vital – even if at times inconvenient – dynamism which this integration implies with the apparent stability of economies still largely confined within the limits of their national market, and linked with the outside world by agreements of a kind which the West abandoned more than twenty years ago. It is quite true that economies linked with each other through barter do not experience monetary crises. But, since such economies necessarily compress the area within which their citizens can exercise free options, they do experience more wounding crises. They are indeed exposed to pressures, and disturbances,



through which individuals try to gain wider scope for freedom of choice.

There is a clear relationship between the domestic productive structure, the international trading system and the methods of its settlement. In systems ordered on bureaucratic lines, where initiative is killed by insufficient incentives and by frustrating controls, it becomes inevitable to sacrifice freedom of trade and payments in favour of bilateral agreements and clearings.

In any case, it appears anachronistic that the values of more open interdependence between markets should sometimes be questioned just at a time when the centrally directed economies are becoming aware of their backwardness and inefficiency, one reason for which is that they are sheltered from the pressure of external competition. To remedy the defects found, they are making great efforts to adapt their internal structure, these efforts being greatly hindered by the lack of managerial talent to interpret the behaviour of the markets, and to take the consequent decisions in good time.

Those experiences are also significant for a country like Italy, which has a mixed economy, where public initiative is accompanied by a keen spirit of private enterprise. They in fact confirm the need to preserve a market based on working competition, in the sense that it is able to test individual capacities, to determine whether the results of production are economical, and to eliminate inefficiency. But it is also essential to safeguard the progress achieved towards international integration of markets. Since the economic environment is often conditioned by great concentrations of production in the private and public sector, by sometimes excessive development of tertiary activities, and by a tendency towards concealed unemployment lurking in administrative positions, the stimulating effects of the market largely depend on its firm integration in the world economy. The advantages of this link do not lie only in the benefits of specialisation, or in the support that external demand provides for domestic production, but also in the fact that active trade with the rest of the world directly and indirectly erodes positions of privilege as well as of inefficiency.

The commitment to eliminate the waste resulting not only from a distorted use of resources, but also from failure to reach realistic production targets, transcends the customary distinction between the public and the private sector. It applies both to the working of the government machine, in its administrative and entrepreneurial roles,

and to that of the economic system regarded as a whole. On the other hand, this commitment, and the task of identifying those basic requirements for a country's social advancement that the market mechanism is not in a position to ascertain, represents the essential significance of a programme where consistency in the choice of objectives is accompanied by a realistic evaluation of the instruments that can be used.

The co-existence of public and private enterprises in Italy has been accompanied by progress which has placed our economy among those industrially advanced, and has enabled it to stand the severe test of international competition. The transformation of the country, however, has raised new problems which relate both to its general progress and to full development of its productive capacities. Since economic facts are changeable, it should not be surprising if the relationship between public and private enterprises changes from being antagonistic to being cooperative, and vice versa. But it remains in any case essential that both the public and private sector shall accept the challenge of external competitive pressure, shall take due account of the Plan's indications and priorities, and shall at the same time derive from the market mechanism the indications which it is especially well equipped to provide, being the centre where a great many independent and decentralised decisions converge for confrontation. Within this institutional framework, our country's deliberate action in opting for an open economy raises awkward problems in connection with financial markets and the banking system. Let us now look at some recent aspects of these problems.

### **The Export of Italian Capital, the Efficiency of the Capital Market and of the Banks**

In a year in which short- and long-term rates of interest abroad reached heights unprecedented in recent history, it was inevitable that the forces of attraction should more strongly affect a system like ours, which combines lower interest rates with a limited range of credit instruments, some of which compare unfavourably with their foreign counterparts. The volume of capital exports, and the disputes which have arisen on the subject, cause us to devote to this matter a

part of this report, beginning from the trend of our accounts with the rest of the world in the medium period.

In the five-year period 1964 to 1968, the Italian balance of payments was characterised by current account surpluses, largely due to the fact that exports grew faster than imports. In the period under consideration, the former increased at an annual rate of 16.5 per cent, and the latter at one of 8.6 per cent. The surplus of 9,200 million dollars on current account was absorbed by capital movements to the extent of 4,400 million. The financing of exports on deferred payment terms, plus credits granted to developing countries accounted for 2,300 million of the outflow. Italy's direct investments abroad, and foreigners' direct investments in Italy, yielded a net surplus of 1,200 million dollars; roughly 60 per cent of the foreign capital invested in Italy is made up by equity participations in Italian enterprises, while barely 12 per cent of the Italian capital which emigrated represents equity participation in enterprises abroad. The remaining capital outflow amounted to 3,300 million dollars, roughly two-thirds of which consisted in bank notes used for investments abroad. Net of minor items, the overall balance of payments showed a 4,000 million dollar surplus; of this amount approximately half accrued to banks, whose foreign position swung from net liabilities of 1,254 million to net assets of 723 million; the other half was acquired by the Italian Exchange Office and the Bank of Italy.

In last year's Report, having found that the performance of the public sector in 1967 was one factor which damped domestic demand, we concluded that an expansionary policy was justified in 1968 by, *inter alia*, the adequate level attained by reserves and by the substantial surplus on current account. At the same time, we again pointed out the disadvantages resulting, on the one hand, from excessive expansion of budgeted expenditure, and on the other from the fact that the latter is not followed by a pace of cash expenditure appropriate to the phase of the business cycle. In July, the government announced a set of measures designed not only to speed up income growth, but also to promote a different distribution of resources between home and abroad. Since an increase in production had to be accompanied by an even faster growth of domestic demand, and hence by an expansion of imports greater than that of exports, the ultimate effect would have been to reduce the surplus on current account. The forecasts for 1969, drawn up shortly after these measures had been adopted, indicated that exports of goods and

services would increase by 7.2 per cent and imports by 15.3 per cent; the balance-of-payments outcome would still be favourable, provided that capital exports were kept below 1,600 million dollars, this being the presumable order of magnitude of the surplus on current account.

On Savings Day, we emphasized that attainment of the objectives described above would not cause any strains on the external accounts, provided that the causes stimulating the outflow of capital, such as the fiscal disincentives and the shortage of financial instruments, were eliminated. The introduction into Italian legislation of small investor's shares and of mutual investment funds, together with the application to both of a tax treatment similar to that prevailing in the markets with which Italy has more direct contacts, appeared – and still appears – to constitute a necessary condition for reducing the outflow of domestic savings.

It is well known that this condition has not yet been fulfilled. The fiscal disincentives with regard to equity capital have impaired the efficiency of the capital market, increased enterprises' recourse to borrowing and caused distortion in their capital structure, probably tending to lower the volume and the quality of productive investments. At the same time, because of the increase in the number of households having monetary incomes which could be spent in part to purchase securities, the dissociation has further increased between the formation and the final investment of savings.

Our inquiries have enabled us to determine the extent of the changes induced by economic progress in the size of households' capital assets, and in the diversification of the ways for employing them: the public's acquisition of financial assets (notes, deposits and securities) basically depends not only on the amount and composition of financial wealth but also on the trend of income, prices and interest rates. Such acquisition is also strongly influenced by the possibility of choice between types of assets having different characteristics, and by the related possibilities of gain or loss on capital account; when the national market is unable to offer shares of a kind which will satisfy savers' preferences, it is inevitable, in a regime of open economies, that such securities will be acquired abroad.

The reform of the tax system as well as that of company law and the setting up of Italian mutual investment funds are proving unexpectedly and damagingly slow. Meanwhile, increasingly well equipped organisations have been offering to medium and small savers, even in our economically less advanced regions, types of

financial investment which are more appealing to them, or have in all events been rendered more attractive by a promotional drive which is both massive and widely ramified. The shift from traditional forms of saving to these forms of investment occurred because the measures which the government had introduced in Parliament as far back as September 1964 have still not been taken.

The country's interest in fact requires rapid approval not only of the civil and fiscal law concerning Italian mutual funds, but also of the company law reform. The success of such mutual funds will largely depend on the tax treatment which will apply to them and to holders of their units; in this context, we would like to repeat our conviction that the taxable income of a fund should include neither capital gains nor the proceeds from the sale of option rights, and that the individual holder should be allowed to choose between paying dividend tax outright or disclosing his holdings to the tax authorities, in which case he would enjoy a tax credit when assessed to personal income tax.

In order that the mutual funds may lastingly perform their useful function for the benefit of the domestic market, it is necessary not only to ensure a wider range of Italian securities to choose from, but also that companies shall be willing to finance their requirements by issuing shares. Both objects can be served by skilful fiscal policy, allowing concessions to those companies which apply for a stock exchange quotation, and lightening the heavy charges which fall on risk capital. In addition, the mutual funds' willingness to include Italian securities in their portfolios will be encouraged by a reform of joint stock company legislation requiring companies to provide more comprehensive information, and better delimiting the powers of the supervisory bodies.

The series continues of big company meetings which are deserted by shareholders and controlled by concentrated holdings of proxies. The series is only interrupted by occasional episodes, due to essentially emotional causes and to the lack of sufficient information. The operations which result in changing the composition of controlling groups take place without any rules ensuring publicity for them; this renders management policy uncertain, and ultimately impairs the prospects for investors. The imperfect rules concerning company records, within the inadequate framework of regulations in force, make it possible to misuse cross holdings; this unnaturally alters the balance of business groups.

As the regulations concerning the capital market have not been adjusted, notwithstanding the profound changes which have taken place in our economy, the credit institutions' urge to look for adaptations likely to make good the defects of legislation, has increased. Thus, for example, the size attained by foreign exchange dealings calls for the organisation of an efficient market in forward lire. But, because of the high taxation on swap contracts, that market has been established abroad, the result being that the Italian fiscal authorities are deprived of receipts, and it is the foreign banks that are the gainers.

Pending legislation which will permit the formation of mutual funds in Italy too, and in view of the growing penetration by placers of foreign securities, we deemed it proper to allow the Italian banks to enter the market, taking part not only in issuing syndicates but also in the management of foreign mutual funds, and in the placement of units of these with Italian and foreign savers. In this way, the destination of Italian capital, if only within certain limits, is decided with the participation of Italian banks. It may be added that the presence of the latter in the management of mutual funds may promote, and indeed has promoted, investment in shares of Italian companies. Finally, the placement through Italian banks occurs subject to observance of the rules in force in our country; any foreign securities so placed are in fact lodged on deposit in accordance with those rules. It should be observed, however, that more often than not such securities are units of growth funds, that is, funds which do not distribute dividends.

Euro-bond issues handled by Italian banks in 1968 totalled 271 million dollars, against 221 million in the previous year; of the total amount 176 million was placed with residents, and 79 million with non-residents, while the small residual balance went into banks' portfolios. Owing to the great expansion of Euro-bond issues during the year, however, the Italian banks' proportion dropped from 9.5 to 6.6 per cent. During 1968, our banks sold units of mutual funds, in Italy, amounting to tens of millions of dollars.

The results of the balance of payments on a cash basis for the first four months of this year show that our fears were not imaginary. For, although net receipts from current items have been greater than expected (although imports continued to recover, the growth rate of exports remained very high), the outflow of capital has been so great that we have had substantially to revise our forecasts about the course

of Italy's balance of payments for the whole of 1969. For the period from January to April, the net outflow of capital, according to figures which are still provisional, was in fact of the order of 1 billion dollars, or roughly twice as much as in the corresponding months of 1968; it is not unlikely that, in the absence of the desired measures, the net outflow of capital for the whole of 1969 may be about 2 billion dollars.

Given these new prospects, it has appeared advisable to adopt certain measures for purpose, on the one hand, of reducing so far as we can the incentive to export capital, and on the other hand of defending our official reserves. Our actions in the first category included bringing the lira rate against the dollar towards the upper limit; the greater cost of currency to be employed abroad, since it increases the risk of loss on reconversion into lire, tends to discourage the export of short-term funds by operators who are sensitive to interest rates. Although figures show that the banks accounted for only a relatively modest share of the capital exports, it was considered advisable, in the new circumstances, to replace automatic permission, with an upper limit as to amount, by case-by-case authorization for participation in international consortia for the placement and underwriting of foreign securities. In addition, the sale of mutual investment fund certificates of all kinds was made subject to authorization, which will be granted only to funds, or sections of funds, when at least 50 per cent of the securities held in portfolio are Italian. The effect was to promote, through administrative measures, the formation of funds which are Italian from an economic point of view, even though not in legal form. But it remains as urgent as ever to secure prompt legislative approval, and fair tax treatment, so as to permit the formation of such funds in Italy too.

On the assumption that during the year under review there may be a deficit on Italy's foreign accounts, we directed the banks, last March, to sell their net foreign assets to the Italian Exchange Office by the end of June, 1969. In the course of April and the first half of May, the banks' net foreign assets were already reduced from 748 to 515 million dollars. Our recourse to this instrument, which greatly assisted us in the control of monetary trends during the 1960s, is not cost-free for the banking system. Among other things, the banks are deprived of the greater income which results from the higher rates of interest ruling abroad. The greatest disadvantage, however, lies in the separation of the Italian banking system from the foreign systems.

The effect of this is relatively moderate on the Euro-dollar market, where the banks are authorised to maintain a gross position, provided that this is in balance. But it is very great on that for new international issues, and indeed may jeopardize the positions laboriously built up by patient action over a number of years. Being aware of this, we do not rule out the possibility that if our fears about the trend of the balance of payments prove to be unjustified, and if institutional conditions in our capital market adequately improve, the banks may again be allowed greater freedom to operate on foreign markets.

The recourse to measures regulating the banks' foreign position confirms, if confirmation were ever needed, that the effectiveness of the interventions by the monetary and foreign exchange authorities depends on the banking system's ability to react. We therefore still seek to ensure that the banks shall retain the flexibility which enables them promptly to conform, at minimum cost, to the impulses transmitted from the central bank. The renewed proposals for reintroducing mixed banks into Italy would appear to conflict with such an aim. The presence of large shareholdings in the banks' assets would increase their rigidity so that monetary policy, if it is to remain effective, would have to use new instruments or else to employ the present ones much more intensively. Besides being less effective, monetary policy would thus also become more hesitant as regards decisions to act: greater instability in asset values resulting in turn from the course of stock exchange quotations would further impair control of liquidity, both in the system as a whole and at individual banks. In Italy, the dependence of credit institutions on direct central bank credit is one of the conditions which, especially in urgent cases, make it easier to apply a quantitative monetary policy, which it is not desirable to weaken.

Against direct investment by banks in industry there are objections on grounds not only of monetary but also of financial policy in general, and of credit policy in particular. Those in favour of the introduction of mixed banks point to the fact that private investment in shares is gradually declining, and the intention to offset the consequent decrease in the supply of savings for enterprises by a new component of institutional character. It appears contradictory indeed to try to remedy the shortage of financial intermediaries from which our markets suffer, not by establishing basic conditions which will allow such intermediaries to rise and prosper but by entrusting new functions to institutions which already exist. Those institutions,



moreover, are already engaged in a great many tasks, which are far from easy, and are governed in their activity by the structure of their deposits. This would certainly not strengthen the capital market.

But independently of the consequences which this would tend to produce in the Italian economic system, as in others, it may be observed that any return to the mixed bank would be bound to harm medium-sized and small industrial firms. Such firms resort on a large scale to borrowing from banks because, unlike the big enterprises, they have no access to the security market. To set up such banks would represent a step backwards from what has been achieved during the last thirty years. Freed from the stockholdings which had hampered their action, the big banks have gradually extended their business to smaller firms. Undoubtedly, the progress of these firms has been directly stimulated by the considerable credit facilities granted to them.

As we have observed on other occasions, the capacity of a public enterprise to obtain funds by borrowing from banks exceeds that of a private enterprise, because the public enterprise is mistakenly regarded as being immune to the risk of insolvency. But the difference in the assessment of borrowers' credit worthiness, nonetheless, does not depend on the public or private character of the lending institution. It can certainly be said that banks of both a public and a private character contribute equally towards meeting the financial needs of private enterprises. The behaviour of credit institutions might be different if they were allowed to acquire the ownership of shares; this might induce the public sector to finance its requirements by issuing shares to be placed with credit institutions directly or indirectly controlled by the government. The situation would be even worse if such institutions were used for gaining control of companies on behalf of themselves or of third parties. Although mobile, the boundary line between the public and the private sector must not be allowed to become evanescent; on that line the survival of the mixed economy depends.

Our objection to banks holding shares is also rooted in other considerations. Given the present phase of our public and private finances, in which the banks' activity is already subject to distortion for other reasons, the protection of depositors requires still closer attention to stability of values on both the assets and the liabilities side of balance sheets. The ratio of equity capital or endowment funds to total deposits is indeed low in Italy because of the post-war in-

flation; the process of building it up again is slow, despite urging by the monetary authorities, and runs into institutional obstacles in certain quarters. It would therefore not be justifiable to adopt a course which would allow banks to take up the entire capital of industrial enterprises, or significant proportions thereof. Such capital is indeed subject to fluctuations in value which are often wide, and are the result not only of greater or lesser competence in enterprise management, but also of ups and downs in the business cycle, speculative factors and external influences. The effect would be to aggravate the risk of capital losses to which banks are exposed because of the large assistance they extend to the enterprises more in need of credit.

It is worth mentioning that a bill recently introduced in the United States would allow the banks to extend their activity into fields which as yet are hardly explored. But even that bill continues definitely to prevent the banks from assuming not only the direct risk of investment in shares, but also the indirect one of participation in holding companies.

The present phase in the evolution of the United States' banking system may be a forerunner of similar tendencies in the Western economies, and therefore merits examination. In that country since the war and above all during the 1960s, there has been an increase in competition between banks and non-banking intermediaries. The banks' success in diverting funds from these latter has entailed an increase in the average cost of bank deposits, the growth of demand deposits having lagged behind that of time deposits, on which the banks are allowed to pay interest. Simultaneously with the change in the attitude towards competition, the American banks are increasingly turning into "financial supermarkets", which provide the most varied services to their customers: from trust administration to leasing, from keeping company accounts to computer services, from travel tickets to insurance policies. The authorities do not seem opposed to extension of the range of services offered by the banking system; but they do rule out the possibility that the said range may be extended to include business which belongs in the capital market and in the institutions which operate thereon.

The changes just mentioned have, of course, been reflected in the legal structure of the banks. Partly because of the peculiar legislation in force in the United States, some of the larger banks have tended to assume the form of holding companies, their object being to coor-

dinate the work of subsidiaries, each entrusted with supplying one of the services into which banking business is being diversified. While the authorities favour the formation of homogeneous groups along these lines, they definitely oppose the formation of conglomerates, which would include not only banks but also industrial, trading or insurance companies. This attitude is based on fear that, if the group conducts banking, productive and distributive activities at one and the same time, this may distort the flows of credit, since the tendency would be to grant credit by preference to companies within the group.

It is certainly true to say that in Italy, too, there has been greater competition on the market for funds. But while in the United States this competition has taken the form of a contest between banks on the one hand, and non-banking intermediaries on the other, in Italy, where such intermediaries are few, the results have been keen competition within the banking sector and consequently a loosening of the interbank agreement on interest rates. The effects of competition have also made themselves felt on the banking structure: in some cases, takeovers have been necessary in order to save depositors from losses; in other cases, a very slight but autonomous tendency towards concentrations or other forms of linkage has been promoted.

We would further emphasize that the anxiety felt by the monetary authorities relates not only to the formation of links running from banks to industrial companies, but also to that of links running the other way. As there are so many public undertakings in our system, this problem may be felt to be less urgent, but it cannot be disregarded. Existing regulations require banks to report to the supervising authority the acquisition of any banking or non-banking interest, and to obtain permission for their own merger; but they do not subject to any form of control the acquisition of one or more banks by a person, a company or a group. We are watching closely the changes in the pattern of bank ownership in Italy, and if the existing state of equilibrium were altered, we should not fail to propose appropriate measures.

Despite the stronger competition between banks, both for deposits and for lending business, the financial results of the banking system as a whole in 1968 were not disappointing. According to information supplied by banks, the unit cost of deposits rose from 3.50 to 3.64 per cent, while the average return on domestic lire lendings remained substantially unchanged at about 7.50 per cent.

The narrowing of the margin between receipts and unit costs was accompanied by an increase in the volume of the mentioned operations. Notwithstanding the rise of overhead expenses, the net operating profits appreciably increased; the increase was mainly due to receipts from services and from dealings in foreign exchange and in foreign securities.

### **The Strengthening of Monetary Instruments, the Action of the Central Bank and the Evolution of the Economy**

The maintenance of adequate control by the authorities requires that improvement of the capital market and banking structures shall be accompanied not only by refinement of the economic policy instruments, but also by a use of management techniques better suited to their respective character and potentialities in directing and, when necessary, checking economic trends. The lesson learned from the experience made in countries where measures to counteract inflation have been chiefly based on fiscal policy is that, with each successive application, the effects of adjustment have tended to become weaker, while the incentives to activity were fading and the costs represented by the distortion induced in the productive system were growing. Inflationary stresses have survived a policy of stabilization not adequately supported by monetary instruments and have led to further restrictive action, the ultimate result being to drive actual income below potential income.

By way of reaction against the inadequacy of fiscal measures, the public have tended – and so have some official quarters – to attach new importance to the value of monetary policy in one of its cruder forms. Once again, we have heard the statement that control of the money supply is the most effective method of keeping the evolution of prices in check, holding it within limits compatible with equilibrium in the balance of payments and with the efficient functioning of an economy based on decentralisation of decisions.

So far, both theoretical analysis and empirical research appear to have excluded only the validity of the extreme views: the view that money is the only truly important variable among the instruments of economic policy, to the point that steadiness in its growth rate is

considered equivalent to stability in the development of the economy; and the view that money is an unimportant variable, since it is assumed that the course of economic activity is determined by the decisions to spend that are passively allowed by changes in the velocity of circulation. Between these two extreme views there is room for intermediate positions in which monetary policy is conditioned by the complexity of economic relationships and by the variety of institutional structures.

While the choice of the variable to be controlled may therefore be the subject of argument from time to time, and from place to place, there can hardly be any doubt about the effectiveness of monetary policy, just as it is obvious that such policy must be coordinated with a selective and flexible system of fiscal measures. In using the different instruments, the economic and social costs entailed by an extensive use of monetary controls cannot be gainsaid, but in the light of recent experience abroad one should not ignore the limitations and delays of a policy of fiscal adjustments, designed to reconcile growth with stability of prices, having due regard for equilibrium in the balance of payments.

It must further be remembered that in Italy the conditions for timely adaptation of fiscal policy to changing economic trends – not only as regards spending decisions but also, and more particularly, as regards their implementation – have not yet been fulfilled. Decision taking does appear to be more rapid when the aim is to impart an expansionary impulse to the economy, as shown by the measures resolved upon last July, than when restriction is needed.

The tendency towards larger budget appropriations as well as bigger deficits in the public sector continued in 1968 too. The result was to accumulate expenditure appropriations which, if drawn upon in full, would cause the public sector to claim a share of both financial and real resources hardly compatible with stability of rates in the capital market or of prices for goods. The overall borrowing requirement is estimated to have been about 3,400 billion lire, excluding expenditure for credit granting; if the latter is included, the amount rises to about 4,350 billion lire. The cash deficit for the whole public sector reached approximatively 1,450 billion in 1968, against 850 billion in 1967; if we add credits granted, the deficit reached, respectively, 2,400 and 1,300 billion lire.

The differences between the deficits recorded at the two phases, of authorization and of cash results, are reflected in the movement of

arrears; this was especially large in the case of the government and of local authorities. If expenditure for redemption of debt is excluded, the increase of government expenditure arrears in 1968 can be put at about 1,000 billion lire, an amount which is considerably higher than the already large total reached in 1967. The greater part of the arrears relate to capital expenditure, which reflects the government's direct contribution towards increasing the country's productive capacity; a high proportion of that expenditure has not yet reached the obligation stage.

The reform of procedures will contribute, in the course of time, towards providing the authorities with more effective means for the management of public expenditure. But the present situation, and that which can be foreseen for the immediate future, do not satisfy the requirements set by a policy which aims at keeping the volume of total demand close to the full employment of factors of production. It is therefore necessary to strengthen the monetary instruments so that these may be better able to control the destabilising forces at work. It is well known, from the analyses contained in this and previous Annual Reports, that the strategic variable through which the Bank of Italy influences the availability of credit, as well as rates of interest, is the monetary base. This latter comprises legal tender money and financial assets which can be deposited without limitations in compulsory reserves, or are freely convertible into cash at the central bank. The principal assets which can be promptly converted into money are: deposits with the Bank of Italy, those with the Post Office, the margin available on current account advances, the liquid surplus of assets over liabilities in convertible currencies, and, up to the end of last April, all Treasury bills.

The experience gained in Italy shows that in the short run the public's demand on the monetary base depends little, if at all, on the central bank's policy; instead, it remains in a fairly constant ratio to the national income. It follows that monetary policy immediately produces its effect on the banks' liquidity, and by this means acts both on bank credits and deposits. This effect appears quite rapidly: within two quarters, a given increase of the monetary base produces, on average, a threefold increase in the supply of credit. It is therefore clearly necessary that the central bank shall be able to control, as fully as possible, the changes in the monetary base.

In the past, the mechanism suffered from a defect which, in certain circumstances, might have impaired the possibility of control.

The defect lay in the fact that the market could, at any time, count on the possibility of converting Treasury bills into cash at the central bank, or directly depositing them as part of the compulsory reserves. As long as the amount of Treasury bills remained moderate, the resulting dangers would have been limited and could, in any case, have easily been neutralised. Once the amount of Treasury bills in circulation increased, however, this would no longer be the case. If, for example, action directed to more rapidly clearing off arrears of public expenditure had unexpectedly swollen the public sector's cash deficit, it might have been difficult immediately to raise the necessary funds on the capital market, as the maintenance of a reasonably stable level of interest rates is conditional on keeping the supply of securities in due proportion to the demand for them. In such circumstances, a large part of the authorities' requirements might have been met through the issue of Treasury bills, thereby creating monetary base.

On these grounds it was decided to separate the Treasury bills in which compulsory reserves are invested from those in which the banks invest their liquid assets. Under the system previously in force the Bank of Italy had undertaken to purchase Treasury bills from the banks at its nominal rate of discount, and to sell them at rates differentiated according to their maturity. Under the new arrangements, on the other hand, the Bank reserves to itself the option, at its discretion, to buy or sell Treasury bills, just as it would for any other security issued or guaranteed by the government. This makes it possible to establish a secondary market also for Treasury bills; on the other hand, these bills cannot be used to meet compulsory reserve requirements.

Thus, the Treasury can now finance its cash requirements with short-term securities not qualifying as monetary base. If, moreover, the amount of Treasury bills issued is kept in line with the cash deficit which is expected to result, after the other forms of borrowing have been used or discarded, and in particular the changes in the Treasury's current account have been kept within narrow limits, disequilibria between the demand for and the supply of funds might occur, with consequent rate fluctuations. These fluctuations will be reduced in so far as the central bank will operate on the market, taking up in its own portfolio of securities the differences between demand and supply.

In conclusion, if the intention is to keep demand on the long-term market as far as possible within the limits of supply so as to

maintain stability of quotations, the excess demand will be transferred to the market for short-term securities, and whenever it proves to be greater than supply, it will cause a rise in interest rates. Obviously, the prices for short-term securities cannot fall for long without this affecting prices on the capital market. If that happened, it would demonstrate the need to reconsider the total amount of security issues, or the rate of interest, or both.

The new mechanism presupposes that changes in the yield on Treasury bills shall be accompanied by adjustment of the rates at which central bank credit is granted; if these rates were kept low and rigid, this might encourage the market to engage in arbitrage, by borrowing at low cost from the central bank and lending to the Treasury at a higher rate. This is one of the reasons why a system has been introduced which provides for progressively rising rates of interest on the fixed-term advances that any one bank obtains in the course of a half year. The chief object of that measure was to keep recourse to the central bank through this channel within limits corresponding to the banks' temporary cash requirements, since the liquidity of the banking system as a whole is adjusted chiefly through our operations in the market for securities. Completion of the mechanism requires that the official rate of discount can also be more often changed. This, in turn, requires separation of the discount rate for ordinary bills from the rate applied to agricultural stockpiling bills. In fact, any increase of this latter rate would only mean a higher charge for agricultural stockpiling and would not help to regulate the quantity or direction of credit flows.

We have implemented a large part of the programme announced in last year's Report, even though the arrangements concerning the banks' compulsory reserves have not yet been revised. If they had been, the result might have been instability of the security market, since the alteration in the flows of funds would have coincided with a situation which had become more delicate owing to international capital transfers.

In our last Annual Report, we stated that during 1968 we would provide the economy with sufficient monetary base to absorb the expected issues of fixed-interest securities, while keeping rates of interest stable. We added that this would be compatible with an increase in bank lending adequate to finance a productive process that would allow income to grow at the average long-term rate in a climate of satisfactory price stability.



Thanks to the fact that the expansion of income at current prices was not very different from that assumed, our forecasts turned out to be substantially correct as regards the relationship between the monetary base, the level of interest rates and the issue of securities. Fixed-interest securities amounting to 3,092 billion lire were in fact placed on the market at unchanged prices, causing creation of monetary base to the extent of 1,199 billion lire. The amount of such securities subscribed by the public, namely 1,360 billion lire, was almost exactly that forecast, and the total expansion of bank lending was also very close to the estimate.

Because some other assumptions on which our forecasts were founded did not materialise – namely, the increase of investment was smaller, the Treasury deficit was greater, the balance of payments surplus higher – the banks' lendings increased less, and their purchases of securities were larger than had been foreseen. The creation of monetary base by the Treasury and by the foreign sector was also greater than expected, with a consequently smaller recourse on the part of the banks to the central bank.

The degree of approximation achieved in our estimates as regards the overall size of certain variables leads us to indicate our views for the current year as well. We anticipate that fixed-interest securities, including free Treasury bills, will be issued in 1969 for a total of about 5,500 billion lire gross and 4,200 billion lire net, of which 2,200 billion lire will be accounted for by the Treasury. Assuming an increase in income of the order of 9.5 per cent in monetary terms, a rise of implicit price deflators kept within the limits of 3 per cent and a balance-of-payments deficit on capital account fairly close to the surplus on current account, we foresee that the public will absorb securities to the extent of approximately 1,600 billion lire; in any assessment of this estimate's reliability, however, account should be taken of the uncertainties which affect subscribers' behaviour. The banks would acquire approximately a further 1,700 billion lire, both for portfolio investments and for compulsory reserves; the Bank of Italy should take up the balance, which includes Treasury certificates issued to settle certain liabilities.

On the assumption that investments increase by about 15 per cent, the banks' lendings should grow by 2,600 billion lire; so that, taking into account purchases of securities, changes in free and compulsory reserves and the variation in their foreign assets, the expansion of the banks' assets as a whole would be in the region of

4,600 billion. On the liabilities side, there would be a corresponding expansion by 4,300 billion lire in deposits, and by 300 billion in the recourse to the central bank and in the other items.

Since the recent increases of public expenditure, it is reasonable to envisage a Treasury cash deficit which, together with that of the Central Post Office Savings Fund and of the autonomous government agencies, will be of the order of 2,500 billion lire. It will be partly covered by placing bonds on the market. Bonds purchased by the Bank of Italy and receipts from postal savings will add 1,200 billion to the system's money supply. Another 300 billion will be supplied through the financing of the banks' recalled non-liquid foreign assets by the central bank and through changes in the latter's other accounts; 900 billion lire of the 1,500 billion thus obtained will go to augment the public's liquidity, the rest being utilised by the banks for their free and compulsory reserves.

Capital exports in excess of the previously mentioned estimate, and such as to lead to an overall balance of payments deficit, in addition to reducing by an equal amount the creation of monetary base, would limit the formation of deposits and demand for securities by the public, while probably having an expansionary effect on bank lending. The possibilities of placing securities on the market would be consequently curtailed. So long as the balance-of-payments deficit were to be about equal to the banks' net foreign credit position, as it stood at the beginning of the year, the Bank of Italy would take compensatory action by purchasing securities on the market, thereby permitting formation of the liquidity required for the purposes indicated above. Such purchases would increase the central bank's security holdings by more than 1,000 billion lire, even if the above-mentioned Treasury certificates are excluded.

According to some opinions, the rate of growth of income forecast for 1969 is below that corresponding to full utilisation of our productive potential, and therefore the issue of securities forecast does not take into account the greater savings which would be available if the increase of income were as great as it would be with full employment. We would point out that the supply of labour is limited in the short run. The bulk of the unemployed is unevenly spread throughout Italy, while the flow of workers to the immigration areas is increasingly dependent upon the provision of social facilities, which advance slowly. What is more, a further acceleration of the diversion of hands from agriculture, as compared with the

already high rate reached last years, would end by creating serious problems in that sector. Furthermore, the closer the growth rate to be reached in the short term is brought to the estimated potential rate, the more accurate must be the evaluation of the constraints set by the balance of payments and by prices. Yet such evaluation entails rather wide margins of approximation due to events, both internal and external, beyond control by the economic authorities.

More important than the results which may be achieved in any single year, not only from the economic but even more from the social point of view, is continuity in the pace of growth. In this connection, the results for 1968 have not been far from expectations with regard to price stability and the growth of income; the latter rose only a little less than the year before solely because of bad harvests. The results did, on the other hand, substantially differ from the forecast as regards the components of total demand; investment and consumption slowed down, leading to a further increase of the balance-of-payments surplus.

In the course of the year, the economic situation has been improving. In industry the advance of productivity, due to investment made especially in machinery and equipment during 1967, and to the employers' caution in engaging workers, as they were uncertain about the course of economic activity, made it possible slightly to reduce the labour cost per unit of output. Given the stability of prices for raw materials and for finished products, there was a consequent increase in unit profits; the growth of total profits was larger because production increased. During the second half year, moreover, the degree of utilisation of productive capacities rose.

The variables which, together with the cost of money (kept stable), more directly affect investment, especially by private enterprises, have evolved favourably, with a movement opposite to that of 1967. Therefore, a recovery in private investment may be expected this year.

Public enterprises too, according to their programmes of expenditure, should further expand their investment activity in 1969; the rate of increase is expected to be considerably higher than last year's. In the building trade a large number of buildings were designed and begun in 1968, after the enactment of the new legislation, and even if measures are adopted to permit their more gradual completion, so as to avoid disequilibria between supply and demand and tensions in

regard to both prices and wages, there is reason to think that such activity will continue to grow at a rate higher than last year's.

If, in addition, the building of infrastructure accelerates, as it is to be hoped (in 1968 it continued to lag behind the country's economic and social needs to the prejudice of the possibility of establishing new industrial settlements and improving the efficiency of the existing ones), the prospect is that fixed investments, as a whole, will increase at a rather high rate.

Employment already started, at the beginning of 1969, to feel the effects of the more favourable economic trend. The process of multiplication and acceleration between investment and consumption appears to be working again. Moreover, direct expansionary stimuli are already exerted on consumer demand by the pay increases consequent on the first stage of the gradual abolition of area differences in wage rates. Similar effects are about to result from the increase of pensions. These should be promptly paid, not only on social grounds but also to prevent the building up of substantial arrears, whose payment in a short period of time would upset the balanced expansion of demand.

Against this prospect of a progressively growing domestic demand, trade union negotiations are now proceeding in the public sector, and in the private sector important collective agreements are soon due for renewal. Wage and salary increases may play a positive role as regards economic growth, both by promoting greater efficiency and by sustaining consumer demand, provided, however, that they are kept within limits compatible with the system's capacity. Over-rapid rises may, on the one hand, generate a flood of additional demand larger than the capacity of supply. The latter's limited elasticity in certain sectors may bring about price rises which would erode the value, in real terms, of the pay increases. On the other hand, because of international competition, price increases may impair the financial equilibrium of enterprises, to the ultimate detriment of the level of employment.

If, during their free negotiations, the parties concerned bear in mind the troubles which not so long ago affected our economy, as well as the more recent experiences in neighbouring countries, and if they act accordingly, agreements will ensue which will both reconcile the interests of the contracting parties and benefit the entire economy. To that effect, those agreements must not only consider the

total size of the increases, but also their distribution over the period covered by the new contracts.

The picture thus drawn appears to indicate that the events which took place in our economy from mid-1967 onwards represented an interruption, now coming to an end, in the process of reviving domestic demand, a process laboriously initiated after the 1964 recession.

This interruption demonstrates how sensitive our economic system is, in the present situation, to disruptive influences. All parties concerned are therefore responsible for ensuring that any influences which may come from the rest of the world shall not be aggravated by others of domestic origin.

The price level, for example, after a lengthy period of almost absolute stability, has again displayed a tendency to rise since last autumn. This was due chiefly to rises in the price of agricultural produce, of raw and building materials as well as, in consumer prices, of services. More recent data indicate that this tendency is getting stronger, especially as regards building materials. Some of these are running up against limits to the capacity of supply, because of the sudden and considerable speeding up of building activity following the new laws previously mentioned, even though, despite opposing pressures, the possibility of placing mortgage bonds has been restricted. On the whole, during the first four months of this year, both wholesale and consumer prices have increased at an annual rate of more than 4 per cent; with effect from May 1, the sliding scale rose by two points, so that during this first part of 1969 it has already risen by three points as compared with the two-point rise which took place in the whole of 1968.

Monetary policy will be affected during 1969 by the uncertainties which prevail in the international sphere, as well as by the contrasting aspects of the Italian economy. The need to adapt the monetary base to the requirements implied by the estimated rate of growth will be met, bearing in mind that the banking system's liquidity must not be allowed to reach proportions likely to cause or promote inflation. But the observance of this limitation depends on the size of the public sector's cash deficit. Our forecast, although based on the assumption of a sizeable increase of that deficit in 1969, would prove wrong if expenditure decisions were to keep up their recent pace.

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Nowadays, perhaps more than ever, we live in a world which abounds in contradictions, both dialectical and real. They are certainly fore-runners of some settling movements. The ultimate result (if "ultimate" can be used for what is yet contingent) may take this or that shape according to the participation and combination of men, events and circumstances. Not yet, or nowhere, perhaps, have confused dialectical and real contrasts been decanted to the clarity of absolute contradiction. It may be that clear dichotomies and emblematical contrapositions are not always possible; perhaps they are not even desirable.

But, in order to keep our comment within our own field, whoever should attribute all value and merit to the market economy, and blame every defect and every fault to its rejection, would run the risk of seeming an unthinking absolutist. Indeed, many people feel that the solution based on the market economy, and the principle by which it is inspired, need to be suitably tempered. Forty years ago, Luigi Einaudi himself wrote that "the economist, faced with actual problems, can never be either a free trader or an interventionist ... at any price". Besides the possibility or desirability of distinguishing between absolute principles and actual needs, the complexity of present-day society is probably another factor that makes some concessions more plausible; the composite structure of this society almost inevitably favours such concessions, blurring the line between the wisdom of equilibrium and the ease of yielding. The fact is that the growing assumption of responsibility by the state, and the consequent shrinking of the private sector's autonomies, may well give rise to the fear that the effects will not be confined to the economic sphere. Indeed, recent experiences, some of them dramatic, warn us that the link by which political liberty and economic freedom appear to be tied cannot be broken with impunity. We have already mentioned that Luigi Einaudi felt bound to reject preconceived positions, just as his honesty made him reject the "laissez-faire" thesis that "everything is permissible". It was Einaudi who said that "the people who are governed and those who govern them create at the same time liberty in all its aspects; that is to say, liberty in politics, in economics, religion, the press and propaganda". And he wondered how men could ever create "economic institutions which bind them and reduce them to a state of slavery", if moral liberty lay at the root of their actions.

There are still people who cannot look at liberty, that fascinating and austere concept, without being moved by it. They seek – and are happy when they find them in their own community – the signs of that concept's vitality and of the institutions it inspires. Fortunately, such signs are not lacking in Italy. They can be found not only in her formal constitution, but equally in the growing interest in the fundamental problems of society, in the differing views over problems and in the diversity of proposals about the action to be taken. They can be found in the expressions of discontent, at least in so far as these can be attributed to the gap between the ductility of imagination and the inevitable hardness of reality, between anxious expectations and the slow pace of achievements. Yet it would be unfair and ungenerous to argue, on the grounds of such discontent, such doubts and such inevitable imperfections, that our system is losing its elasticity. We have a system which is, by its nature, open and capable of benefitting from criticism, of progressing and of renewing itself. We do not doubt that it has as well the moral strength to do so. Nor do we doubt that the virtues of this system will enable us to proceed further along the road on which we so fruitfully set out more than twenty years ago: the road to civil and economic improvement, which we ought to follow respectful of liberty as well as of the variety of institutions, of conditions and of choices.