Concluding Remarks for 1970

The "Anti-recession" Policy in the United States and its Repercussions on the International Monetary System

For many years, the Bank of Italy has devoted special attention to international problems, especially those of a monetary nature, in the conviction that failure to solve them can produce adverse effects on the growth of our economy. On numerous occasions, we have expressed the desire for a coordination of the economic policies of the various countries that should not be brought about merely by the fortuitous pressure of events but should benefit by the advantages of prior deliberation. We have also pointed to the inadequate understanding of economic mechanisms as a factor contributing to the persistence of particularistic views and attitudes which impede such a development.

At the time of our meeting last year, the state of the world economy already suggested the possibility of conflicts between the aims of domestic policies of the countries which exert a predominant influence over the more general trend of economic activity and the aims, even openly declared, of international cooperation. We then concluded our examination of the cyclical variations in the United States by asserting that an accentuation of the signs of economic recession might finally have induced the United States government to adopt expansionary policies, with the ultimate result that the supply of dollars would have continued to be abundant on the international markets to the extent of arousing fears as to the viability of a system of relationships between currencies based on fixed exchange rates.

Looking back over 1969 and 1970, it can be seen that the policies pursued in the United States were designed to bring about, first of all, a slowing-down of the rate of increase of overall demand and, afterwards, a moderate expansion. In 1970 the increase in unit costs was smaller than in the previous year; prices went on rising at a rate faster than was to be assumed from the behaviour of other economic magnitudes, such as the ratio of actual to potential production and the rate of increase in unemployment. Even American experts have difficulty in linking the causes of the resistance shown by prices with the phenomena which usually curb their rise. Some of the causes have been stated to lie in the persistence of impulses due to an inflationary process which has continued on an unprecedented scale for more than five years. Others have been attributed to the structural changes under way in the social system, with special reference to those relating to the concentration of economic power.

The conclusion of major labour contracts took place during the transitional phase from a period of intense inflationary pressure to a period of moderate inflation; but the new contracts incorporated solutions which reflected a belief in the continuance of inflationary phenomena and the desire to protect the future purchasing power of wages from any new rises in the cost of living. These modes of behaviour were not displayed only in the sectors where labour is organised on a trade union basis. The major enterprises, for their part, did not resist them, feeling certain they could pass on the increased costs to prices, thanks to the market power which they possess; this power is therefore a component of the inflationary process, additional to that represented by the increased power of organised and unorganised labour.

While inflationary impulses due to stronger expectations of their continuance can be combatted by appropriate combinations of fiscal and monetary policy designed to regulate demand, the impulses stemming from costs cannot be corrected by pursuing these policies without strongly affecting the level of employment. If the decisions to increase prices of the factors of production are not matched by an adequate money supply, the ultimate effect can be a liquidity crisis for enterprises, insolvency and bankruptcy. When these phenomena assume socially unacceptable dimensions, even in the United States recourse has to be made sooner or later to state intervention, mainly in the form of government orders.

Inflationary explosions are also possible when actual demand does not exceed potential production: the concentration of demand in one or more key sectors of the economy brings about price increases which, by changing the relative positions, in turn induce increases in the remaining sectors. The strengthening of activity in the dynamic sectors creates a greater demand for labour, raw materials and machinery; the prices of these factors of production go up and induce, within a certain length of time, a progressive rise of costs in other sectors. If they have sufficient market power, these sectors also raise their prices, causing a further upward spiraling of the general level.

In the United States, these phenomena appeared in the industries more directly concerned with production for defence, but, even when demand in these industries slackened, the upwards momentum imparted to prices throughout the economy continued. An attempt was made through monetary policy to dampen these impulses, by refusing to finance the production process at rising prices. The limit to this, however, was set by the capacity of enterprises to withstand liquidity crises; that this limit was approaching became absolutely clear in June 1970, when the insolvency of a large rail transport company appeared imminent. Confronted with these developments, monetary policy became expansionary, and was reflected in the formation of large holdings of funds in the banking system and in the downturn of interest rates. In addition, monetary policy endeavoured to bring back to the banking system the task of financing business. During the period of tight credit, the large enterprises had raised short-term capital by direct placing of commercial paper with the public; as we had occasion to emphasize in the previous Report, this phenomenon was intensified by the banks' inability to compete with enterprises by offering higher interest rates. In order to avoid certain undesirable consequences, the banks of the Federal Reserve System informed their associates that they would widely rediscount the portfolios of those among them who had given assistance to corporations in difficulty. This arrangement proved inadequate to achieve its purpose and, immediately afterwards, was accompanied by the suspension of some of the ceilings on interest rates which the banks were allowed to pay on certificates of deposit and time deposits. Thus, an end was put to that process of disintermediation of the banking system, which had sometimes assumed paradoxical forms in the period of the credit squeeze, when it was seen that the regulation of bank liquidity produces serious distortions if it is prevented from transmitting its effects to the economy through changes in interest rates.

During 1970, the growth rate of the money supply was raised to 5.4 per cent; given the conditions of the real economy, the velocity of circulation slackened and bank liquidity increased. While this was happening, the banking system rejected funds previously attracted via the Euro-dollar mechanism; despite measures designed to restrict the flows of funds from US parent banks to their branches abroad, an impressive outflow of liquid resources began to develop.

Consequently, the problem of the Euro-dollar became more urgent. In 1959, a member of the present Board of Directors of our Bank raised, at an international meeting, the problem of the repercussions of the activities of the reserve currency markets on national economies, resorting, in order to express succinctly the possible inflationary developments, to the word "contamination", which at that time provoked indignant reactions.

Through a natural evolutionary process brought about by the passage of time and the refinement of technical knowledge, the activities of these markets became increasingly important in domestic financial policies, while simultaneously the view gained ground that they also acted as a vehicle for the spread of inflation in the various economies.

The volume reached by the liquid assets in dollars created by the United States balance-of-payments deficits, which, in turn, are further magnified by the activity of the Euro-market, is such as to undermine the patient attempt to construct on the basis of the Bretton Woods Agreements an economically and socially balanced system for the international exchange of goods, services and capital. This clearly appeared from the recent monetary crisis.

The support given by the dollar to the system of international trade, at a time when the inadequacy of the traditional instruments was accompanied by a decline in the international role of sterling, is undeniable. It was thought, however, that its use represented a transitional solution until such time as the community of nations had provided itself with a suitable organisation and appropriate instruments. It was also stressed that, in principle and with specific reference to the dollar, a system of virtually fixed exchange rates could not be based in a stable manner on currencies playing the dual role of domestic and international monetary reserves.

Experience has abundantly proved that the more use world trade makes of a national currency, the more the international markets and the economies of the countries open to foreign influence are exposed to the changing cyclical conditions in the country creating that currency. For if the authorities who govern the market from which that currency originates subordinate the balancing of their foreign accounts to their domestic aims and resort to the monetary instrument to control inflation or revive production, the rest of the world becomes involved in the same direction of that choice.

This technical observation is in keeping with the more general consideration that such a system tends to encourage the development of political conflicts, which increase distrust between countries and slow down the process of world economic integration.

The introduction of the special drawing rights appeared to have opened the road to a rationalisation of the international monetary system, but obstacles are piling up along this road, owing to the impossibility of keeping under control the United States foreign accounts and the international money-creating mechanism set up, particularly in Europe, by the foreign branches of American banks and by European banks. As long as the effects of this creation were on a modest scale, the world economy, although reacting to them, was able to absorb them; but today international monetary disturbances have acquired such strength that the re-export of the flows they produce brings about reflux waves that rise higher and higher at each turn.

Some economists maintain that international markets are abstract entities. The banks of the various countries, they contend, interchange between themselves liquid funds denominated in dollars or other foreign currencies to exactly the same extent that they receive them from depositors. The result is that the increase of net official reserves in dollars is, on paper, equal to the deficit of the US balance of payments (when the latter is expressed in terms of official transactions and to the extent that the deficit is not financed by the country's own reserves) plus the dollar reserves injected into the market by the central banks. Unquestionably, this proposition is correct, as is also the assertion that a reduction in the deficit in terms of liquidity of the above-mentioned balance and the discontinuance of the practice of depositing official reserves on the Euro-market would, in the absence of other stimuli, have the effect of regulating the volume of that market. But to deny that the banks as a whole have the power to expand their own operations within wholly discretionary limits, against assets which they regard as liquidity reserves, is to ignore the very essence of the multiplier mechanism of international means of payment, which is at one and the same time the effect and the cause of the United States balance-of-payments deficit and of the over-expansion of official foreign exchange reserves. If one were then to infer from this argument that no reason exists for extending to international banking activity the use of instruments which have been tried out within the national sphere, it must be concluded that the attempt of the authorities of the leading countries to maintain the liquidity of their systems and the official foreign exchange reserves at the desired level is destined to remain frustrated.

The Euro-market is nothing but the sum of those sections of the countries' bank balance sheets which are denominated in foreign exchange, mainly US dollars. Such bank assets and liabilities, like any other item in the balance sheets, are based on certain liquid assets which are voluntarily held by the banks in order to cover the risk of declines in their deposits. However, those held in connection with domestic operations are also covered by compulsory reserves, composed of monetary instruments (not only currency) especially chosen and regulated by the monetary authorities to limit the expansion of bank assets. By contrast, the domestic authorities do not require any deposit of reserves (except under temporary regulations imposed to meet contingent situations) in respect of the items denominated in foreign currencies, nor are they individually able to indicate and regulate those instruments which the banks regard as liquidity covering their operating risks. Moreover, the banks, aware that, in the event of cash difficulties in reserve currency, they can turn to their own central banks, presumably keep their demand for precautionary reserves within modest limits. Consequently, in the case of banks operating on this market, the flow of liquidity resulting from an initial deposit in dollars – whether made by a private individual, a US commercial bank or a central bank elsewhere in the world – passes from hand to hand and diminishes at each turn by only a fraction, intended to ensure the liquidity of operations in that currency; provided, of course, that the central banks or the individual operators do not deposit this liquidity in the United States for their own use.

An examination of national monetary policies applied to the Euro-dollar market, or the Euro-currency markets in general, shows that the individual countries have been chiefly concerned with regulating the net position abroad of their banks rather than the volume of their assets and liabilities in terms of foreign exchange. In other words, they have mainly attempted to isolate the creation of domestic monetary base from external influences, ignoring the fact that this base, in an integrated economy, cannot escape the effects of the flows of funds which bank intermediation can create.

Consequently, the monetary policy of most countries has hitherto implicitly accepted a system of voluntary reserves as the only limitation on the supply of international bank money. The fact that, until recently, the supply of such money was relatively modest may be due to a certain segmentation of the markets, to temporary obstacles created by certain countries and to the fear of recurrent monetary crises, and thus to the restraint which the banks, in view of this, may have spontaneously exercised. As very little is known about how these restraining factors behave, a policy that continues to be based on the acceptance of discretionary reserves alone as the factor limiting international activity of the various banking systems maintains, in the present monetary structure, an element of uncertainty regarding the development of international trade and domestic economies themselves.

Measures should therefore be studied for bringing the supply of international liquidity back under control so as to restore to the monetary authorities the possibility of guiding domestic financial systems in the direction regarded as most compatible with freely chosen aims.

It should be pointed out straight away that, in view of the great adaptability of international markets to new forms, dimensions and techniques, unilateral decisions would have the effect of damaging the intermediaries of the countries adopting them, while partial regulations, for instance those confined to the Euro-dollar to the exclusion of the other Euro-currencies, would have the effect of producing atrophy in the controlled part, and an expansion of transactions not subject to regulation. Consequently, if a decision is reached to regulate the markets, concerted action is necessary together with general measures applying to all countries, whether or not they have balance-of-payment surpluses or deficits, to all markets and to all operators.

Solutions designed to regulate the credit potential of the Euro-dollar market must apply both to sources of its liquidity base and to the use made by the banks of the foreign exchange liquidity they acquire. It should be recalled that the propagation effects emanating from the Euro-dollar market can spread in opposite directions. The experience of recent years shows that the inflationary impulses of 1970 were preceded by the deflationary impulses of 1969.

Control of the sources of liquidity base raises once more the subject of the exchange rates between gold, the dollar and other currencies, which has been discussed several times in previous Reports.

During the last few years, there has been a progressive deterioration in the United States balance on goods and services at a time when the function of the dollar as a reserve currency appears to be weakened technically by the higher average rate of inflation of the US economy in comparison with the past and by the prevalent use of monetary policies by the US authorities. The possibility cannot be ruled out that the recent worsening on current account may have been partly due to fortuitous situations, but it is more likely that it was the result of reduced competitiveness of American goods and of the acquisition of greater technological independence by the rest of the world, at least with regard to goods which most directly affect the US balance of payments. It cannot, however, be deduced from this that the rest of the world can accept solutions which maintain untouched the full freedom of financial flows by placing the burden of the adjustment on trade in goods and services.

At the beginning of this year, we already had occasion to point out that the persistence of serious US balance-of-payments disequilibria might render necessary a technical solution which, depending on the magnitude of the monetary flows in dollars in the rest of the world, could take the form of a widening of the margins of fluctuation of currencies around their parities against the dollar, of a change in the parities against gold or the dollar, or of the abandonment of the present system whereby the dollar must be purchased by the official authorities in unlimited quantities. If this were regarded as undesirable or impracticable, the necessity would arise of a control over capital movements, by the United States or the rest of the world, to be applied by the issuing of administrative rules or by the creation of a second dollar market for dealings in the dollars derived from financial operations. One form of intervention could be the systematic carrying out of operations of the type performed this year by the Export-Import Bank and the United States Treasury; these, by changing the balance of the United States foreign payments, could produce the desired effect, provided that they were carried out in agreement with the monetary authorities of the countries concerned and designed to reabsorb the international liquidity base before the banks should multiply it by credit-granting. The monetary authorities are tending towards the use of these operations in order to combat incipient problems arising from the United States balance-of-payments deficit.

In view of the magnitude reached by US liquid liabilities held by official organisations and private individuals, and the ability of the banks operating on the Euro-market to procure in various ways the liquidity they need, control of the primary source of supply of Euro-dollars cannot alone solve the problem of guiding the international money supply in the desired direction, unless the solution is chosen of abandoning the present institutional order of the exchange relationships between currencies or of forcibly sterilising the United States sight liabilities or replacing them by other, non-liquid financial instruments.

Thus, on the one hand, it is necessary that the official organisations should re-examine the desirability of persisting in policies designed to export unwanted international monetary flows and of allowing themselves to be guided in the management of their reserves by criteria which are not appropriate to the purposes for which they hold them; on the other hand, they must also regulate the expansion of the items of the individual countries' bank balance sheets which are denominated in foreign exchange, both by stating expressly which liquid assets must be held in respect of these items and by manipulating, by agreement between all the countries, the ratio which is to exist between liquidity and foreign exchange lendings or deposits at each phase of the business cycle.

What has been said forms the basis of a wide and closely-knit range of solutions, which do not rule out the possibility of continuing along the road towards the establishment of a system inspired by the principles of Bretton Woods. But the countries must be willing to draw up a common scheme of intervention on the international financial markets, pari passu with the implementation of the plan for creating reserve instruments that are independent of the behaviour of individual economies.

There seems to be a consensus of opinion regarding the nature of the crisis which broke out at the beginning of May: it was apparently due not to undervaluation of the European currencies in terms of the US dollar but to the inflows of capital brought about at first by the divergence between the monetary policy pursued in some European countries and that applied in the United States, and subsequently – because of the exceptional magnitude of these flows – by the increased expectations that some currencies would be revalued, with the cumulative effect which such expectations exert on capital movements.

The solutions adopted by the various countries for dealing with the crisis, considered individually, fall under the logical heading of measures designed to regulate the supply of dollars for international use. As, however, they were not the result of concerted action to combat the causes of the phenomenon, we believe that these solutions do not entirely meet the objections raised against an unconditional development of international monetary flows and the operation of the mechanisms which generate them.

In basic contrast with the spirit of all the above-mentioned measures is the argument that international monetary problems – and not just those arising from the functioning of the Euro-dollar market – can be fundamentally solved by a general uniform increase in the price of gold not differentiated in relation to the dollar and other currencies. This argument, which we examined closely three years ago, has not in the meantime been sustained by any further knowledge lending support to its underlying hypothesis. The essence of the problems connected with the international use of the dollar lies first and foremost in the magnitude of the US balance-of-payments deficit and not in a lack of confidence in the ability of the United States to honour its debt, provided, of course, that solvency is not interpreted narrowly in a way that recalls anachronistic principles connected with the gold standard system. Any nominal increase in the value of the United States gold reserve, therefore, besides necessarily being of so large a size as to be unacceptable in practice to ensure that it met that country's current total liabilities, would be unable to eliminate the existing disequilibria in the exchange rate relationships between the main currencies or – still more – to give an impulse to the mechanisms for the deliberate creation of international liquidity, thus avoiding the present state of dependence of the international financial system on the cyclical trend of the individual countries' foreign exchange balances. Lastly, it would not meet the need to gain control over the autonomous centres that originate international means of payment, which have been widely discussed; on the contrary, if it were really able in practice to restore greater confidence in the dollar, it would give such markets renewed vigour.

A possible start towards a coordinated monetary policy, at least within the European Economic Community, was offered by the resolution passed last February by the EEC Council of Ministers on the basis of the recommendations put forward by the so-called Werner Report, supplemented, with regard to the foreign exchange system, by the analysis made of it by the Committee of Governors. Italy fully supported this move, being keen to participate in such a far-reaching European scheme; she nevertheless expressed some doubts regarding a line of policy which, despite our efforts to maintain a certain harmony between the convergence of economic policies and progress in the field of monetary relations, persisted in giving precedence to the latter, mainly by emphasizing the necessity of restricting the margins of fluctuations in exchange rates within the Community. In our opinion, the insufficient coordination of the economic policies of the member countries of the Community, the different degrees of domestic inflation in each of these countries and, especially in some cases, the magnitude of capital movements made it appear questionable whether the prerequisites exist for starting a process of progressive reduction of the margins of fluctuation, which should culminate in the establishment of irrevocably fixed exchange rates between the Community currencies.

In particular, our suggestion to leave the margins unchanged for relationships within the Community and to create more room for manoeuvre in relation to the dollar by widening the present band to 1 per cent on either side of parity, pending institutional changes on a world-wide scale that would permit margins of up to 2 or 3 per cent was not accepted. Instead it was ultimately decided to reduce from 0.75 to 0.60 per cent, with effect from June 15, 1971, the band of fluctuation of the dollar on the Community markets around the so-called Community level; but the decision had to be deferred, owing to the aforementioned foreign exchange crisis.

The measures proposed by the Commission of the European Economic Community to deal with the crisis seemed capable of being effective, provided, however, that they were adopted in their entirety and by all the countries together. It also became clear that some of the measures could not have been applied immediately and that others, although in accordance with the needs of the moment, would have been able to produce their effects only in course of time.

These measures, accepted by the Council after examination by the Committee of Governors and the Monetary Committee, proposed, in addition to the establishment of a control over the sources supplying the Euro-dollar market and, at the same time, over the credit-expanding process which takes place through that market, to limit the entry of short-term funds into those countries where this could prejudice the implementation of the monetary policy. The proposals essentially aim at facilitating control over the creation of monetary base within the individual countries by dissociating it, within certain limits, from the effects of the foreign component.

The plan proposed by the Commission was accepted by all, including the representatives of the Federal Republic of Germany. Views differed, however, regarding the urgency of preparing measures that should be immediately effective. Consideration of the urgency of finding solutions to her own problems induced Germany, after consultation within the Community, to suspend application of the previously existing margins of fluctuation around parity with the deliberate intention of discouraging new inflows of liquid funds by introducing an element of uncertainty regarding the yield expected.

The dismay caused by recent events may help to reinvigorate the political will of the member countries to strenghten the Community, in view of the serious problems still unsolved.

One of these, which seems to be approaching a successful solution in the very wake of the recent foreign exchange crisis, is constituted by the negotiations with the United Kingdom and the other candidates for membership of the Community.

From the monetary point of view, one of the difficulties which have emerged concerns the position of sterling in an enlarged Community, since it is incompatible with Community membership for any national currency to be allowed to serve as a reserve currency for the rest of the world, or for part of it. Such a function, or that of an intervention or reference currency for the linking-up of the currencies of non-member countries which choose to gravitate economically around an enlarged Community, could only be performed by the single common currency of the future Economic and Monetary Union.

However, the gradual elimination of the sterling balances held by the countries economically associated with the United Kingdom cannot be achieved unless they are offered as a replacement an alternative reserve instrument in which they would find it convenient to invest their reserves. It is in the interest of the future Economic and Monetary Union that this should be a Community instrument.

If this and the other obstacles still standing in the way of the United Kingdom's entry can be removed, the result will be the formation of a far more balanced Community in which the decisions will increasingly reflect, instead of the bargaining power of the member countries, the blending of national interests with those of the Community.

In last year's Report, we pointed out that, in view of the inflationary pressures in the world economy and the different ways in which they appear, it might have been difficult to reconcile a greater degree of economic interdependence with a system of fixed exchange rates; this might have led to the need for recourse to moderately flexible exchange rates. Such an innovation, we concluded, might stimulate the transformation of the European Economic Community into an economic union with interchangeable currencies on the basis of irrevocably fixed exchange rates, their monetary relationships with the rest of the world being regulated on the basis of fluctuating rates.

The decision recently adopted by the German government might have provided the occasion for an approach towards the solution then suggested. We felt, however, that our country could not seize that opportunity, owing to the difficulties with which our economy is struggling: investment is still apparently stagnant, private consumption seems to be restrained, building activity is still declining, industrial output has fallen and foreign trade in goods and services is showing a deficit. We shall now go on to discuss these problems.

Outline of the Italian Economy in 1970. Domestic and Foreign Demand. Costs, Prices, Profits

During 1970, the expansion of domestic demand, particularly pronounced at the beginning of the year, was not accompanied by a sufficiently large increase in production; a substantial proportion of the additional demand was met by increasing imports, which led to a reduction in the surplus on goods and services account of 1,300 million dollars, representing 1.6 per cent of the gross national product. It was thus possible to contain the effect on prices; nevertheless, the inflationary component in the growth of income was 6.3 per cent, exceeding that of the real component, which was 5.1 per cent. In the period January-August, which is the only period for which the past two years are comparable, owing to the effect of the strikes in the latter part of 1969, manufacturing output – the added value of which represents nearly 90 per cent of that of the industrial sector – increased in 1970 at roughly only one-third of its 1969 rate.

The slowdown, which, both for the whole sector and for the main categories of industry, does not seem to have been due to the reaching of full utilisation of existing productive capacity, appears as stagnation if we examine the trend during 1970; seasonally adjusted, the level of activity at the end of the year was the same as at the beginning, and the situation deteriorated in the early months of 1971.

The imbalance between demand and supply was not uniform for all the sectors of industry; it was more marked for metallurgy, means of transport and textiles, for which the volume of exports levelled off, whereas that of imports rose considerably. For mechanical engineering, imports recorded a very high rate of growth, while sales abroad slackened. Lastly, the chemical sector, although also showing a deterioration of its trading surplus, achieved an expansion in exports after the standstill of the previous year.

The moderately restrictive monetary policy pursued since the middle of 1969 – as soon as the inflationary component of national income seemed to be increasing to such an extent as to begin to exceed real growth, and there were signs of a further worsening of the balance of payments because of difficulties on current account, too – has acted as a brake on prices. Nevertheless, prices for manufactured goods moved up at an annual rate of 11 per cent during the first five months of the year, which subsequently slackened down. The adoption of this policy also helped to reduce capital exports, through the raising of interest rates, which were gradually brought into line with those prevailing on the international market. This move was supplemented by administrative measures which curtailed the export of banknotes.

Monetary management, on the other hand, involving the abandonment of the policy of stable interest rates, had repercussions on the capital market, where issues of fixed-interest securities contracted by about one-quarter from 1969 to 1970. The decline was offset by borrowing on the international market; in this way, a balance-of-payments surplus was also achieved instead of a considerable deficit, which would have happened in the absence of these loans.

The economic trend was influenced by an exceptional increase in costs, all the more serious as productivity gains, instead of remaining high or even increasing with the recovery in output, slackened. The economy was unable to counter the effects of wage increases either through rapid rationalisation or a sharp expansion of investment; new projects stagnated. The vigorous growth of domestic demand in the first part of the year was accompanied by a contraction in supply, due both to the reduced possibilities of using productive capacity owing to the implementation of the provisions of the new labour contracts and to various forms of labour disputes. This started a process which began with a decline in output, leading to the slower formation of income and hence to a weakening of demand. On top of this came the serious effects of the slowing down of building activity. Finally, symptoms of recession appeared. These trends appeared not only in backward sectors but also in advanced ones, especially the capital-goods industries.

The rapid progress made by the Italian economy in the last twenty years was due, during the greater part of the 1950s to the introduction of new technologies, coupled with the use of labour of steadily improving quality. Subsequently, the large expansion in the years 1959-1963 increased and strengthened the country's productive potential; after 1964, the progressive use of this potential and the improvement of business efficiency, obtained by the formation of units of better dimensions and by better combinations of the factors of production, enabled our economy once more to achieve a vigorous rate of expansion. Under present-day conditions it appears difficult to prolong this phase, not only because less technical innovations remain to be introduced but also because the new labour conditions, the persistence of strikes by non-trade union groups and absenteeism force enterprises to reorganise production schedules so as to regain the necessary margins of flexibility and, in some cases, to decentralise plants. This leads to results which deserve our attention.

Between 1960 and 1969, total employment in manufacturing industry increased at an average annual rate of 1.00 per cent; as the number of hours worked per employee declined by 0.7 per cent, the total number of hours worked did not change appreciably. The whole increase in output was achieved by a rise in hourly productivity of 6.9 per cent per year. During these same years, enterprises usually responded to changes in demand, in the short term, by making less than proportional adjustments to their payrolls, since they could regulate the hours worked by the manpower employed.

If we confine the comparison, for the reasons stated above, to the first eight months, we find that from 1969 to 1970 the tendency towards a decline in the number of hours worked per employee became more marked; the use of the labour factor still remained practically unchanged, since the reduction in hours worked per employee was offset by an almost equivalent rise in employment. The volume of goods produced increased to a moderate extent; hourly productivity went up by 4.5 per cent and that per employee by 1.5 per cent. This was also influenced by the tendency we mentioned to substitute hours worked per unit of labour by using additional manpower; in fact, even if this accords with the aim of modifying non-optimum labour conditions, it not only renders company management more rigid in making the necessary adjustments to cyclical phases, but also, at least at first, causes a reduction in productivity, due to the time inevitably needed to fit new workers into the production line.

The difficulties of reconciling better working conditions with the orderly development of productive activity, combined with the frequent recurrence of conflicting situations within companies, made cost-planning impossible and finally acted as a disincentive to the investment through which the economy would normally have endeavoured to restore the conditions necessary for the reconstitution of the capital employed. In the field of public building, many calls for tenders met with no response, since builders were unable to foresee the extent of the increase in costs during the period of execution of the work.

In past years, we have repeatedly emphasized the need for an expansion in capital investment which, taking full advantage of the possibilities offered by the formation of savings, would accelerate the extension and strengthening of the productive apparatus and allow the necessary social and economic infrastructures to be prepared. We have always directed our own efforts to this end by trying to encourage the inflow of the necessary financial resources at the most convenient rates possible.

In the industrial sector, which is more sensitive to market pressures, the middle of 1968 saw the start of a vigorous recovery in investment, on the part of both public and private enterprises, impelled by the gradual reduction in the margins of unused capacity and the favourable trend of profits, and assisted by the ample availability of financial resources. This phase was interrupted first by the exceptional events of the autumn of 1969; then, in 1970 – after a brief recovery largely due to installation of machinery which it had not been possible to carry out in the latter months of the previous year – it petered out, owing to the disappearance of the conditions which had stimulated it. The average results for the year do not reflect this change, because of the way in which the events described followed each other during the two years, and indeed show a greater increase in industrial investment than in 1969. This was mainly due, however, to public enterprises, since the contribution of private firms, even on the basis of annual figures, was rather small.

A glance at the indicators of economic activity for 1970 shows that the appearance of a tendency towards a decline in demand from quarter to quarter was in fact mainly due to the trend of investment expenditure, considerably influenced by the building crisis. This is also evident from the data on industrial production, the stagnation of which, between the beginning and the end of the year, was largely attributable to the capital goods sector. Another factor contributing to the unsatisfactory trend of investment in 1970 was the degree of availability of credit, which is fully discussed in the chapters of the Report. We shall confine ourselves here to mentioning the essential aspects.

In last year's Report, after quoting the estimates of the Technical Scientific Committee of the Ministry of the Budget, according to which, in 1970, the average increase in the cost of labour per person employed in the whole economy was put at 13 per cent and the increase in industrial workers' actual earnings was expected to range between a minimum of 11 per cent in sectors not subject to renewals of labour contracts and a maximum of 21 per cent in the others, we stated, on the basis of successive indications, that the increases would probably be greater. These estimates and our assertions were disputed; it has to be admitted that the estimates were subject to error, but of the opposite sign to that suggested by the critics. The increases in fact turned out to be much greater than had been forecast; in manufacturing industry earnings, according to the Ministry of Labour's statistics, available for the first three quarters of 1970, increased on average by 23 per cent with peaks of 27 per cent in the metal-working and mechanical engineering industries, and 33 per cent in the chemical industries. The impact of such large rises was not confined to the branches in which wage contracts were renewed but spread to all sectors, owing to the share of wages in the prices of the goods and services exchanged within the productive system. In every sector of manufacturing industry the increase in costs is thus attributed to two factors: one direct, namely the increase in wages within the sector in question; the other indirect, namely the increase in the prices of goods bought from other industrial sectors; this is the aspect which illustrates that the concentration within a limited period of time of the effects of the renewal of many important labour contracts is detrimental to the equilibrium of the economic system.

Redistribution of income can raise the level of consumption and, when there are unemployed or underemployed factors of production, stimulate higher production. But if, at the same time, as in fact was the case, changes occur in the relationships between costs and prices leading to widespread uncertainty regarding the possibility of reconstituting the capital employed in production, investment decisions inevitably slow down and the mechanisms tending to restore balance, which in a different situation would have stimulated increases in output, help to bring about the new balance by lowering the level of employment. Instead of moving towards higher equilibrium levels, the economic activity loses ground.

I have felt it my duty to underline the consequences resulting from a refusal to admit the links connecting these phenomena, and I continued to do this even at times when the trade union disputes had reached the highest degree of bitterness.

At the end of November 1969, I had occasion to assert, among other things, that considerations relating to general public order, and also to the re-establishment of discipline within enterprises, suggested the desirability of expediting the settlement of the current trade union disputes. The preservation of the representative nature and authority of the trade union organisations was in the general interest, particularly if the government, in consultation with these organisations, was willing to face the problems of a reform of national health service institutions and similar questions. These are the reasons that impelled a settlement of the disputes, rather than the gravity of the losses of production and income caused by the strikes, which are the inevitable price of a system of labour relations based on respect of the freedom of action of the parties concerned. But the greater the concessions made because of contingent considerations, the more, I said, would the solution of future problems be complicated.

With regard to the possibility of the wage increases being absorbed by the industries affected by the contract renewals, I emphasized the difficulties which would be encountered, especially in the engineering industries. Numerous engineering firms, I asserted, would be unable to bear the new burdens and would thus be exposed to the risk of bankruptcy; nor did it seem acceptable to assume that an intensification of investment brought about by credit concessions would have made it possible to increase productivity sufficiently to restore balance in enterprises within a short time. It should be borne in mind, I said, that engineering firms employ labour to a proportionally greater extent than other industries and are more affected than others by international competition, so that they find it less possible to pass on part of the cost increases to prices.

As to employment, I added that, assuming that the increase in wage costs would have forced engineering firms to attempt to economize on the labour factor, this would inevitably have resulted in a lessening of the incentive to create new jobs. The shortening of working hours could have operated in the opposite direction to the extent that the burden on costs had been found bearable.

Extending the survey to the whole system, it had to be asked whether, in view of an increase in the prices of investment goods largely supplied by the sectors affected by the new labour contract, enterprises in the other sectors would not also have been forced to consider curtailing their capital expenditure programmes in real terms. I concluded that, if this should happen, repercussions on total employment would be inevitable.

Subsequent events appear to have largely confirmed these statements. The size of the increases in the unit cost of labour in 1970, and of those which are still due, rules out the possibility of their being passed on to prices to the extent and with the timing necessary to avoid a strong impact on profit margins. It should be remembered that these events, unlike the similar ones in 1964, took place at the end of a period during which there was no strengthening of the productive system such as occurred in the five-year period 1959-1963. In this situation, a policy of forced expansion of demand, insofar as it was not reflected in greater imports, might have led to even higher rates of increase in costs per unit of output, owing to the depressive effects on productivity resulting from the heterogeneous capital structure of our productive system, to which we referred in the previous Report, and to the accentuation of the wage drift. The amount passed on to prices would have been relatively smaller and the resultant squeezing of profit margins would have been proportionately greater. An analysis of the results for last year and the previous years confirms that enterprises' profit margins are a decreasing function of the rate of acceleration of labour costs per unit of output; the repercussions on the propensity to invest of private enterprises, especially in the case of smaller firms, are automatic and largely independent of action taken by the central bank. The delays in and the limits to the adjustment of prices to increases in costs are the greater the stronger is the impact of domestic and international competition.

In an economy which, like that of Italy, is open to the international market, those tensions which originate from costs force out of the market, for economic reasons, whole enterprises, or at least the part of their plants which can no longer be profitably operated at the new level of costs; in other words, inflation produces deflationary impulses which start a painful process of adjustment. The erosion of enterprises' profit margins caused by frictions which delay and constraints that limit the alignment of price changes with the higher costs of management, the resultant repercussions on self-financing by enterprises, the prospect of a lower rate of yield on investments and thus the reduced propensity to invest, are all factors leading to an inadequacy of overall demand which tends to feed on itself.

When, last summer, signs of a cyclical trend of this kind appeared, the direction of economic policy altered so as to strengthen the components of demand represented by social investment and consumption, accelerating at the same time the expansion of the money supply. We shall mention later the limits to the creation of money; but we should like to emphasize that, in view of the present institutional structure of the economic system, changes in financial aggregates are of little effect when the process of price formation for the productive factors and for products changes in such a way as to have an adverse effect on the formation of capital. There can be different opinions as to who should be given the power of deciding on the accumulation of capital and its use; but it is not possible to desire economic progress and at the same time not to desire the accumulation of capital.

Total financing of the domestic sectors (households, enterprises and the public administration) increased substantially, rising from 7,650 billion lire in 1969 to 9,500 billion in 1970. The increase was, however, mainly accounted for by the part absorbed by the public sector and particularly the Treasury, which, net of funds transferred to other sectors, rose from 1,930 billion lire in 1969 to 3,370 billion in 1970. Consequently, despite the impressive increase in overall financing, the amount that went to the economy in 1970 was only 7.2 per cent more than in 1969. Since in the second half of 1969 credit expansion had been somewhat contained, the total credit supply to the economy suffered a restriction which appears even greater if account is taken of the increased need for floating capital and the higher cost of capital goods, all accompanied by reduced self-financing.

Throughout the greater part of the year, that is, until about the end of the third quarter, the supply of bank credit was contained owing to our interventions in the second half of 1969 and the first half of 1970 and to the lag with which the system reacts to them. Since during the same period there was an excess, in relation to supply, of demand for credit, even at the higher interest rates charged by the banks, phenomena of rationing occurred, through the shifting of funds between the various sectors of the economy and, within these, towards the big enterprises. Financing was concentrated on industry and especially on the mineral oil and chemical sectors; the funds mainly went to state-owned enterprises and to the large private enterprises which carry out far-reaching investment programs, spread over long periods, and need credit that is more stable and less sensitive to changes in economic conditions. Small enterprises, in a precarious state owing also to the greater difficulty of passing on cost increases to prices and, unlike state-owned enterprises, not immune to the danger of insolvency, suffered most from these conditions.

This phenomenon is clearly revealed by an examination of the data of the Central Risks Office on the distribution of the increases of credit lines classified by size. The concentration of such increases had not varied appreciably during 1969; an analysis of the quarterly data shows that the distribution of the increases was very close to that of the initial totals. From the first quarter of 1970, on the other hand, a sharp fall was noted in the share of credit lines of amounts below one billion lire compared with the total. From the second quarter, the share of the categories comprised between 1 and 20 billion lire also decreased. In the fourth quarter, a normal position was re-established, owing to a faster increase of the lines of credit of more modest amount.

Not only in Italy but also in most countries with market economies, when demand for credit exceeds supply, the banks tend to exclude the excess demand by reducing the proportion provided to the higher risk customers. The rigidity of the interest rate structure in Italy accentuates the phenomenon of credit rationing and, when this occurs, the choices are influenced not only by objective considerations, that is, regarding the quality of the enterprise, but also by subjective considerations, preference being given to enterprises directly or indirectly controlled by the state. Proof of this assertion is furnished by a comparison between the average increase for all bank loans from December 1969 to September 1970, amounting to 4.4 per cent, and the increases for some groups of enterprises in the public sector, ranging between 25 and 48 per cent, and for local authorities, amounting to 26 per cent. Towards the end of the year, the pressure of the large groups on the banking system decreased, both because some of them took advantage of the greater possibilities of borrowing abroad, and because the special credit institutions accelerated the disbursement of loans previously granted.

An important factor distorting credit policy is the pressure exerted by local authorities and national health service institutions in search of funds. Lendings to them are the source of high profits for the banks concerned, but can also entail the tying-up of large sums, thus worsening the banks' liquidity situation. Furthermore, being intended for the financing of deficits caused in most cases by payments which, for social and political reasons, are absolutely unpostponable, such lendings limit the autonomy of the banks and, when the latter run into cash difficulties, of the Bank of Italy itself. But the more the banks' field of choice is restricted, the more they are obliged to resort to rationing. This phenomenon is one of those which actually reduce the effectiveness of a market economy based on the multiplicity, variety and renewal possibilities of economic initiatives. Thus, just as the defence of an efficient and dynamic system of mixed economy must be ensured by avoiding unexpected shifts in the line of demarcation between the public sector and the private sector, it is likewise essential that this demarcation line should not also mark the boundary between a privileged area and one which is at a disadvantage in obtaining credit.

Administration of External and Internal Liquidity. Short- and Long-term Credit. Interest Rates

In recent years, the authorities responsible for economic policy have been faced, more clearly than in the past, by aims which are difficult to reconcile with each other: it has not always been possible to promote sustained growth of income under conditions of price stability while at the same time maintaining a satisfactory equilibrium in the foreign accounts and in employment. In 1970, after an 18-month period of balance-of-payments deficits, our policy was first to restore and then to raise the level of our foreign exchange reserves, in the conviction that availability of adequate reserves constitutes a safeguard to ensure that policies designed to defend the level of employment are not frustrated by balance-of-payments crises. The accumulation of reserves entails a cost which has, as a counterpart, the greater degree of freedom which can be achieved in decisions of economic policy. This is all the more true, the more an economy is open to the international market.

The forces which can produce swings in the balance of payments have become stronger. The decline in the productive system's ability to adjust to changes in the volume and composition of demand entails greater recourse to imports. The high degree of dissociation between the centres where savings are formed and those which carry out investments, exposes our economy, more than others, to the danger of shifts of funds to other markets. Similar consequences are produced by the failure to adjust the structure of the domestic capital market to the international market and, in particular, by the fact that our market does not, at present, offer forms of investments which can compete with those on the international market, although the most recent experience has shown that the greater attractiveness of certain foreign investments can prove illusory.

In last year's Report, we had occasion to recall the increasing difficulties which capital exports were creating for our balance of payments and the measures adopted in 1969 and the early months of 1970 to combat their further expansion and cope with their consequences. In addition to the monetary policy decisions taken in order to create general conditions capable of discouraging capital exports, mention was made of the following measures: the starting of heavy borrowing abroad to meet public and private credit requirements, though utilisation of the lire proceeds was staggered so as to limit the impact on domestic liquidity; the shortening of the periods within which those engaging in foreign transactions must make payments and collections; and the centralization at the Bank of Italy of the crediting of banknotes received from abroad, a measure which, by lowering the exchange rate applied to banknotes, helped to bring about a substantial reduction in such outflows. On the other hand, the need to finance the balance-of-payments deficits entailed repatriation of the net foreign assets which the banking system had previously built up, the mobilization of the lines of credit available from the monetary authorities of the United States and the adoption, in the management of reserves, of criteria suited to the needs of the moment, such as utilization of the credit position in the International Monetary Fund.

We have, on several occasions here, drawn attention to the main forces which govern capital movements. Recently, the main pressures causing capital outflows have been due to the interest rate differentials which appear from time to time between the domestic market and foreign markets and to a number of factors, primarily of a non-economic nature, represented by the reactions of business operators to the ups and downs in the country's social and political situation; reactions which, among other things, have helped to increase the importance of the different tax treatment of capital income in Italy and elsewhere and of the search for more varied forms of investment for financial savings. Towards the middle of the year, when the interest rate differentials in favour of foreign countries had been eliminated, only the last-mentioned factors remained to explain the further exports of capital, despite the restrictions imposed on them by the foreign exchange regulations in force.

Speculative movements against the lira, due also to persistent rumours about possible parity changes, reached unusual proportions, mainly during July and the first half of August, and then suddenly ceased; the sudden change in the outlook caused serious losses to speculators. In order to give an idea of the scale of the measures taken by the Bank of Italy to defend the exchange rate of the lira during these months of special tension, it may suffice to recall that the volume of interventions in 1970, up to mid-August, totalled about 1,700 million dollars, of which 450 million relate to July and the first half of August alone.

During the last four months of 1970, the policy of greater borrowing abroad by public agencies and enterprises requiring funds was pursued further. The reason for the continuation of this line of policy was the need to provide an alternative to recourse to the domestic market, with a view to encouraging the downward trend of long-term interest rates and, despite the reduction in the capital outflow, the desirability of strengthening our reserves by raising medium- and long-term funds on the international market.

Whether the volume of a country's reserves and the degree of liquidity of their components are adequate depends not only on economic and financial variables, such as imports in terms of their volume and their elasticity in relation to income, the level of domestic liquidity and of the country's foreign indebtedness, but also on more imponderable factors which can all be attributed to the degree of sensitivity of the market to a succession of economic, financial, social and political events, both national and international. Everything seems to indicate that the market has been reacting more sharply to such events recently, and that circumstances therefore require, in view of the increasing integration of markets, a wider margin for manoeuvre in order to combat possible outbursts of speculation, which recent experience has shown are becoming more violent and sudden.

At the end of April 1971, Italy's net official reserves totalled 6,178 million dollars, representing a rise of 1,482 million at December 1969; 55 per cent of these reserves consisted of gold, special drawing rights and other gold-guaranteed assets, while the remainder was in convertible currencies. The rise in the reserves over the last sixteen months, totaling about 1,900 million dollars, was due entirely to an increase in convertible currencies. Set against these sight assets, however, there are medium- and long-term loans taken up during the same period. From the point of view of the overall financial position of the country in relation to foreign countries, matching between foreign exchange debit and credit items covers the exchange risk. From this point of view too, therefore, the obtaining of appropriate yields on reserves should take precedence over exchange risk considerations.

Foreign loans made to Italian residents and received during these sixteen months totalled about 2,600 million dollars; most of the funds came from the Euro-market, and the remainder from national markets, especially the German market. Without such loans Italy's balance of payments would have closed with a deficit of 1,900 million dollars instead of a surplus of 700 million.

With the reconstitution of an adequate level of reserves, the policy regarding the raising of funds abroad was modified; no restrictions are imposed on attempts by enterprises or other bodies to obtain credit outside Italy, provided that it is at long term. This attitude is based on the desirability of consolidating previously contracted indebtedness and at the same time avoiding the concentration of excessive burdens on the balance of payments for particular years.

In this second phase, it was also thought advisable to restore the longer periods within which exporters can collect their outstanding credits, while maintaining for importers the period of 30 days applicable to advance payments; to raise all the ceilings within which the banks can deviate from the required balancing of their foreign exchange position; and to give the banks the power to act as direct intermediaries between foreign markets and Italian enterprises requiring medium-term credit, on an equal footing with foreign credit institutions.

In the present situation, there does not seem to be room for any substantial increase in the financing of exports with deferred payment and of Italian works projects abroad. Admittedly, this type of financing to some extent improves the current account of the balance of payments, but it is also true that it increases the volume of foreign lending which is tied up and subject to risk of loss.

The restoration of an adequate level of reserves also lessened the constraints on the creation of monetary base which had prevailed during the first half of 1970; the result was an overall expansion of the monetary base during the year considerably greater than had been forecast, namely, 2,154 billion lire against 1,750 billion. It should be recalled in this connection that each year the Inter-Ministerial Economic Planning Committee determines the overall distribution of monetary flows among the various users, in accordance with the lines of development laid down in the Economic Programme. When the government budget is being prepared, the Committee lays down the amount of the changes in the main financial aggregates during the financial year covered by the Budget. These amounts are announced in the Forecasting and Planning Report and the ministers concerned usually comment on them when the Budget is being discussed. It is therefore astonishing that most people think the financial aggregates are decided upon the initiative of the central bank and that no comparison is made between actual results and forecasts, nor is any attempt made to find the reasons for possible discrepancies. It also appears to be believed that the central bank has the power of causing the credit volume to rise or fall instantly; we think it desirable to dispel this belief and to mention a few causes of friction which prevent changes in monetary base from immediately affecting credit.

In 1970, the large amount of monetary base created, and the public's tendency to make less use of it, brought about, from the summer onwards, an expansion in bank reserves of nearly 1,200 billion lire, which is much more than in the preceding years. In relative terms, the increase during the year was 20.0 per cent, whereas that in bank credit, consisting essentially of lendings and investments in securities, was 11.3 per cent and that of deposits 16.1 per cent.

The divergence between the rate of expansion of the banks' liquid reserves and that of credit is partly attributable to the fact that the increase in the reserves was concentrated in the second half of the year and that there is normally a time-lag before the banks' activities reflect the impulses given by the monetary authorities. If we consider the length of time required for changes in the monetary base to produce their full effect on the credit volume or on interest rates, or on both, it can be inferred that the trend of credit in 1970 was influenced throughout practically the whole year by the declines in liquidity which took place in the second half of 1969 and the first five months of 1970.

In order to throw light on the development of the supply of credit, a calculation has been made, for each quarter of the last three years, of the maximum theoretical supply of bank credit, taken to mean the maximum expansion of such credit compatible with the level of the reserves at the banks' disposal, taking into account the time lags necessary for the multiplier process. It is found that the supply of credit rose at very modest rates from June 1969 to September 1970 and only showed a marked increase at the end of the year. It is also found that, whereas in June 1969 actual credit represented about 75 per cent of the maximum supply, at the end of 1970 the proportion had risen to 86 per cent. This increase, which implies growing pressure of credit demand on supply, also led to an appreciable rise in interest rates.

Mention may also be made of the following further reasons for the smaller expansionary effect of the monetary base created in 1970: the greater variability with which it flowed into the economic system, at least partly due to the irregularity with which the Treasury's cash requirements occur; the abandonment, in the summer of 1969, of the policy of supporting bond prices, which had the effect of depriving the system of second-line liquidity; and the shift of deposits towards sight accounts, which increased the marginal compulsory reserve coefficient and thus reduced the deposit multiplier.

Lastly, the supply of bank credit was greatly restricted in 1970 by the cutting down of the Bank of Italy's financing to the banks, which at least partly offset the large expansion in Treasury expenditure financed by monetary means. This was particularly the case in the first quarter, when the very heavy Treasury requirements and the impossibility of meeting them by capital market operations made it necessary to cover them by recourse to the central bank. The slowing down of financing by the Bank of Italy applied particularly to the bigger banks, which are more dependent on such financing, and these correspondingly reduced the rate of increase of their lendings. The total creation of monetary base for financing the Treasury and the banks was nevertheless very large during this period, reaching a seasonally adjusted figure of 1,000 billion lire; but the balance of payments removed about 250 billion of this and the absorption by the public was also exceptionally great (about 600 billion lire). The banks as a whole were able to expand greatly their deposits and investments in securities all the same, though they were obliged to encroach to some extent on excess reserves in order to adjust their compulsory reserves.

In the second quarter, the pressure due to the financing of Treasury requirements lessened; though the uncertainties of the social and political situation obliged us to operate in a state of permanent alarm – which incidentally was not unjustified, as was subsequently confirmed by the events of July and August – the Bank of Italy increased its financing to the banks by a sum which, seasonally adjusted, amounts to 450 billion lire, in order to prevent the erosion of monetary base brought about by the balance-of-payments deficit from having excessive repercussions on the banking system's credit-granting potential. The total creation of monetary base during this period and the increase in bank reserves were very large (the former amounting to about 750 billion lire and the latter to 400 billion, the increase in these being concentrated in June). But the supply of bank credit still fell short of demand, which went on rising rapidly, primarily owing to the increased costs borne by enterprises. Actual credit expansion thus came close to the potential limit; interest rates rose and by themselves helped to restrict demand.

The emergence of a balance-of-payments surplus made it possible, in the second half of the year, to expand liquidity creation to a considerable extent. The rate of growth of total bank credit remained moderate, however, owing to reduced investment in securities. In a second phase, demand for loans also slackened owing to the full development of the disequilibria which had induced firms to review fixed investment programs; in December, there was a certain revival of demand for bank loans. From the summer onwards, there followed a progressive increase in the ratio of liquidity to deposits, a slowing down and subsequent cessation of the upward movement of lending rates and a reversal of the rising tendency of bond prices.

The banking system turned over to the Bank of Italy part of the liquidity it had received, at first in order to reduce its indebtedness and then, from the beginning of 1971 onwards, in order to place deposits with it. At present, the banking system has a larger credit position in relation to the central bank than ever before. This has resulted in a downward pressure on lending rates, encouraged by the Bank of Italy, which first reduced the rate on advances and then the discount rate.

The balance-of-payments deficit had a stronger effect in reducing deposits in the case of the bigger banks; these were also hit, as has been mentioned, by the containment of financing by the Bank of Italy. As a result, the bigger banks, from the second half of 1969 onwards, had raised the rates on inter-bank accounts and begun a more active campaign to attract private customers by offering more advantageous rates on deposits. This gave a boost to the rise in deposit rates, which spread throughout the whole system and made it impossible for the inter-bank agreement to be confirmed at the end of 1969.

The high remuneration on bank deposits, coupled with the difficulties encountered by the capital market, led to a large increase in the funds collected, especially in the second half of the year. At the same time, the abundant creation of monetary base, all of which went to the banking system, provided the resources necessary for depositing the required reserves and increased the system's expansion potential. The rate of increase of deposits during that period was very high, partly owing to the changed origin of the monetary base; in fact, the part of this which flowed into the banking system through the Treasury deficit and the balance-of-payments surplus had an inmediate impact on creation of deposits, independently of the operation of a multiplier process. In addition, the permission given to the banks to take, from the tied accounts constituting the compulsory reserves, sums for investment in securities issued by industrial credit institutions led to an increase in the deposits, first of these institutions and then of their customers, equal in amount to the increase in the banking system's liquidity.

With the consolidation of the expansionary line of monetary policy, the banks abandoned the sharper forms of competition, thus creating the prerequisites for the re-establishment of an agreement on deposit rates. The new agreement, initially concluded between the bigger banks, provided for maximum limits on the rates on large deposits, while leaving the rates on smaller deposits free. This agreement, while satisfactory for the banks advocating it, was not so for the smaller ones, which would thus have been exposed to competition from the big banks for deposits of modest size, which for the smaller banks represent a large proportion of the funds administered. Thus, an agreement was reached which provides for a classification of deposits by size and fixes the maximum rates applicable to each class. This method appears to have achieved the aim of curbing the rise in deposit rates but not that of reducing the average cost of deposits, since the rates have tended to cluster around the upper limit for each class.

Our investigations regarding the effect of the rate of inflation on bond yields in Italy seem to contradict the assumption that these yields basically tend towards stability in real terms. It should therefore be pointed out that sectors which are more sensitive to considerations of yield may shift their investment from the domestic to the international market. A stabilizing effect on financial yields is exerted by regulation of the supply of bonds, implemented by making new issues subject to authorisation, and by the policy of intervention on the market pursued by the Bank of Italy; this policy, abandoned in the summer of 1969, was resumed, systematically but in new forms, in May 1971.

Experience in fact suggests that investors attach great importance to the stability of bond prices; their dislike of price fluctuations induces them to buy bonds bearing nominal rates close to the actual ones, as those which, if interest rates rise, suffer the smallest reduction in their market values. It could thus be thought that, in a rationally organised market, adjustments in the terms of new issues should mainly be made in the nominal rate and in the life of the loans, the issue price being left around the par value. This kind of policy is currently being pursued on the international market and on the major foreign markets, but runs up against difficulties in our country.

These difficulties will be lessened when a unified capital market is established within the European Economic Community. Progress in this direction is to be made in the ways and with the timing laid down by the decision adopted last February by the Council of the Community. It should be recalled that the member countries have agreed, to this end, to harmonise their monetary policies and unify their instruments of intervention. The latter are conditioned by the institutional framework within which banking activity takes place.

Thus, adaptations of this framework cannot be made by autonomous decisions of the individual member countries. The solutions will emerge from the wishes expressed by each country; they cannot be undertaken at the national level.

Credit, Saving and Investment in a Market Economy

In public discussions, monetary policy is often held responsible for a low volume of investment and consequently for an insufficient rate of growth of income and a high level of unemployment. The following arguments are heard: in order to produce more, more credit is required; credit has been restricted or not sufficiently expanded; therefore the party responsible for this has prevented more from being produced. What has been said so far will help to show how little such arguments do justice to the complexity of the interrelationships between monetary phenomena and real phenomena. We propose, nevertheless, to pursue further the examination as to the limits within which the supply of credit can help to solve concrete problems.

A condition of equilibrium in the economic system is that all of the financial instruments issued in order to cover the financing requirements of the public sector and the private sector shall not exceed the volume of gross financial saving desired by the public, when the maximum employment of the usable resources has been reached. If this condition is not fulfilled, there are pressures on the level of prices and losses of foreign exchange reserves; the financial mechanism ceases to act in support of the expansion of the real economy, but operates only by inflating its monetary size. Another condition is that the public's preferences regarding the forms in which it wishes to employ savings shall correspond with those of borrowers concerning the forms in which they wish to obtain finance. If this condition is not met, the ultimate result may be a decline in the public's propensity to hold financial instruments.

Looking back, and also observing current events, it cannot be said that these conditions are always met. The equilibrium has been disturbed by the joint action of the changes in institutional systems and in the public's preferences. An effect in the same direction may be produced by other changes which can be expected to occur in the near future.

Recent years have seen a pronounced trend towards an increase in the proportion of financial savings invested in foreign assets, entailing a reduction in the volume of funds available for the final users within the country. This trend is partly due to the wish of investors to diversify their assets and to the impossibility of meeting this wish on the domestic market owing to the lack of financial instruments that can compete with those offered by the international market.

This change in the structure of financial assets causes a decrease of the amount of monetary base. The central bank can take action to offset this by purchasing the bonds issued by the public sector or enterprises which have not been taken up by households. This was the policy pursued by the Bank of Italy until the summer of 1969. The decrease of the monetary base caused by the capital account deficit of the balance of payments thus did not affect the volume of credit available within the country throughout the period when there were no inflationary tensions.

The expansion of financial assets, however, is also conditioned by the existence of types of credit instruments with which the borrowing sectors intend to finance themselves; in other words, enterprises are not indifferent to the various ways in which funds can be raised; in fact, credit instruments are not completely interchangeable or equally accessible to the various kinds of borrowers. Thus, if for institutional reasons, or because of market conditions, the possibilities of obtaining funds by means of appropriate instruments are limited, the overall volume of financing may also be reduced and productive activity may shrink as a consequence.

In point of fact, the monetary authorities can help to adapt credit instruments to the requirements of financing of the planned level of investment, mainly through regulation of the monetary base, both quantitatively and from the point of view of administrative constraints that link it to deposits, but this task is complicated by the high degree of separation between the centres of savings accumulation and those which decide their investment.

An index of the magnitude assumed by this phenomenon in Italy is offered by the upward trend of the ratio of the changes in the economy's financial liabilities to the gross product of the private sector. The change in the economy's financial liabilities between 1951 and 1958 averaged 8 per cent of the private sector's gross product, whereas in the period 1959-1970 it rose to 13 per cent. As a substantial proportion of borrowing is for the purpose of financing capital investment, the ratio of the change in liabilities to investments may be regarded as an index of the external financing of the investments, even though an approximate one, since financial liabilities are also issued for the acquisition of financial assets by enterprises.

By deducting from the amount of external financing an estimated sum for the economy's indebtedness connected with housing, and relating the remaining part to gross private investment excluding housing, we obtain a ratio which rose from 34 per cent in 1951 to 59 per cent in 1970. The external financing of the housing sector has also increased, but remains at much lower levels, having risen from 28 to 32 per cent. Our economy has thus become more exposed to the danger of discontinuity in the process of investment.

In the period between 1951 and 1970, the share of risk capital in the economy's total liabilities fell from 40 to 27 per cent. The growing excess of enterprises' investments over their savings was therefore financed by short-term and long-term borrowing, which replaced risk capital. The long-term borrowing of enterprises, however, was not matched by an equivalent amount of long-term credit from the sectors in which savings are formed. Consequently, the activity of the financial intermediaries ended in the transformation, on an increasing scale, of short-term funds into credit instruments suitable for financing investment. The volume of these transformations rose from an annual average of 280 billion lire in the period 1951-1958, representing 9 per cent of investment, to one of 1,770 billion lire or 22 per cent in the period 1959-1970.

Present-day problems of the building sector also entail important financial aspects. The process of industrialization has been accompanied in our country, and in a large number of Western countries, by the phenomenon of urbanization, which in turn has aggravated that of the formation of differential rents in housing. The process is reflected in faster increases in house prices and rentals than in building costs; the rise in rentals helps to increase the pressure to obtain wage increases and thus stimulates the rise in costs and prices. The elimination of differential rents in housing as a possible source of financing for construction activity raises the problem of the substitutes to be introduced into the system in order to promote the financing of an adequate volume of housing suitable for the requirements of a society in which the phenomena of urbanization appear to have become a permanent feature. If the importance attached in other countries to public building, or at any rate to building guided by the public authorities, is to be approached in Italy, this will impose a structural transformation of the means of financing construction: a part of households' savings which formerly went directly to investment in housing will have to be directed to the purchase of securities by means of which building is financed.

This will lead to a further increase in the supply of financial instruments and will raise the problem of how they will be received by private investors.

Over the years, we have increasingly investigated the reasons on which enterprises' investment decisions are based. Factors contributing to these decisions are expectations concerning the trend of demand, given the degree of utilisation of productive capacity, expectations regarding profits and the development of technology; further factors are the desire of enterprises to maintain or possibly to enlarge their share of the market, the possibilities of obtaining sufficient credit to cover the gap between investment and self-financing, and the assessment of the risks attaching to a more or less high level of borrowing.

An examination of the balance sheets of a large number of industrial enterprises shows that, each year, the increase in investment in equipment is in direct proportion to the rate of the enterprise's internal saving in the previous year. The rate of saving is higher in large enterprises, which helps to explain the greater rise in the fixed capital investment of these enterprises in recent years. During the period 1963-1969, the average rate of gross self-financing worked out at 81 per cent in the larger enterprises and at 59 per cent in those with net capital assets of not more than 2.5 billion lire; this confirms that smaller enterprises are more subject to the effects of changes in the availability and cost of credit. In 1970, the rise in investment in industry as a whole was attributable, even more than in the previous year, to public enterprises whose investments expanded by 42 per cent. In the case of private enterprises, the rate of increase was 15 per cent at current prices and little more than 4 per cent in terms of volume, and most of this was due to the activity of the bigger companies.

Self-financing is of decisive importance in the growth of small enterprises, for which it appears as an exogenous factor, whereas large enterprises, under oligopolistic conditions, themselves have the power, in a closed market, of influencing self-financing via prices. If, on the other hand, we consider an open market, the argument concerning small enterprises can be extended to larger ones.

Thus, self-financing has become the strategic variable in any development policy which is to be based on a substantial contribution from the private sector. In a system in which the degree of self-financing has shrunk, it is in itself difficult to find, in appropriate forms, financing for directly productive investment. This now happens in a situation where the process of investment is affected by aims, such as that of remedying regional and social disequilibria, which in the short term reduce the profitability of investment and thus further curtail the formation of wealth within enterprises. There is thus competition between productive investment which also serves a social purpose and productive investment for profit, but in the use of financial capital both also feel the impact of investment, such as that of local authorities and health services. Although, considered individually, all these requirements may be justified, their simultaneous satisfaction seems to be incompatible with the volume of financial resources that can be supplied by the system under conditions of price stability.

The view appears to be spreading, however, that these problems could be solved by recourse to the Bank of Italy, either by means of drawings on the current account held with it by the Treasury, or when the possibility of drawing on this account is exhausted, by presenting Treasury promissory notes for discount.

It seems that any difficulty can be solved by recourse to borrowing. If it is urgent to assist this or that sector which is in difficulties, it is arranged that the government shall intervene by borrowing money from the Credit Consortium for Public Works. It will be the consortium's duty to issue bonds; someone will subscribe for them, otherwise the Bank of Italy will fill the breach. If farmers revolt because certain contributions are paid late, the solution is to provide the Treasury with a sort of executive instrument which gives it the power to call upon the Bank of Italy to pay. Our system has thus come to include recourse by the Treasury to extraordinary advances from the Bank of Italy, as during the war and the immediate post-war period, perhaps owing to the fading of the memory of the serious consequences which ensued.

The banks, in their turn, have to be generous in credit-granting to large and small enterprises, to provinces, to municipalities, partly also because they will be assisted by new forms of insurance. Enterprises should borrow without hesitation: the large ones because they will have sufficient power to impose their will on the banks; the small ones because, sooner or later, they will find themselves helped by increasingly large credit concessions and ultimately by interventions of public financing companies.

It has, in fact, been proposed to extend to credits granted to small and medium-sized industrial enterprises a sort of insurance equivalent to that provided to exporters. The function of the banks would thus be degraded into that of dispensers of money on behalf of the government, but this would not necessarily make their behaviour any bolder; probably the opposite would happen, because the banks are not unaware of the harshness of the procedures to which they would be subjected when the government guarantees were to be applied.

It has also been proposed that two yearly-redemption payments on the loans granted by the industrial credit institutions should be postponed. It seems superfluous to emphasize the grave consequences which this would have on the activities of those institutions and on monetary equilibrium in general.

In view of the greater difficulty experienced by small enterprises in passing on cost increases to prices, and of the high level of indebtedness which limits their further access to credit, it has been proposed that industrial enterprises with no more than 500 employees at the end of 1970 should be temporarily relieved of the burden of part of the contributions to be paid to the national social security institutions. This would have the effect of establishing a sort of extra-corporeal circulation, since part of the higher costs borne by enterprises would be refunded to them by the issue of securities subscribed for by households, to which higher incomes have been distributed. But this is obviously a kind of relief which can only be effective when there is a short-term imbalance between costs and prices. If the effect of the measure providing for the taking-over of part of the contributions by the government were to stimulate demands for higher wages, the measure would achieve results opposite to those desired.

It has also been proposed to refund the turnover tax on industrial investments during the period preceding its replacement by the value added tax; this would clear away an element of uncertainty which might have led to the postponement of investment decisions. The financial effects would be similar to those of the above-mentioned measure: financial resources would be provided free of charge to enterprises by borrowing them from the household sector and leaving the redemption burden to be borne in future years.

Lastly, the taking-over by the government of the higher prices paid for replenishment of fuel-oil supplies boils down to a tax reduction financed by borrowing.

Last summer, measures were adopted for finding new sources of revenue for financing part of the deficit of the public health service institutions. The effect of these measures in 1970 was to increase the government sector's deficit, since the amounts supplied to these institutions totalled over 200 billion lire, while the increased tax revenue, in view of the arrangement permitting petroleum companies to defer payment of the manufacturing tax to the Treasury, was no more than 100 billion lire. For 1971, despite the fact that these measures are producing their full effects on revenue, the deficit of the Treasury, the autonomous government agencies and the Central Post Office Savings Fund can at present be expected to reach a considerably larger amount than that corresponding to a state of balance in the economic system if the objectives stated in official documents were achieved.

These objectives, in view of the trend during the first few months of this year, do not appear to be attainable unless there is a rapid expansion of demand, accompanied by an increase in production.

It seems unlikely that investment will reach the total of 14,000 billion lire mentioned in the aforesaid documents; the slackening of building activity is continuing, although this tendency may be moderated by the operation of the counter-cyclical measures approved by Parliament; in addition, the implementation of the far-reaching public building program, now being approved, will necessitate an adaptation of administrative structures and will, even if the financial problems are solved, therefore upset the course of building activity for some time to come. Furthermore, to judge by the combined trend of production and foreign trade in capital goods, directly productive investments show no signs of acceleration. Public enterprises and some big private firms are carrying out large-scale projects located, in accordance with the objectives of the Programme, mainly in southern Italy and concentrated in certain basic sectors. But the activity of the other enterprises, largely medium-sized firms, is still stagnating with consequences which might be seen particularly in the northern regions.

Private consumption does not appear to be providing any appreciable stimulus, at least as far as can be deduced from the trend of employment and wages. Employment is still tending to rise slightly, but there is much greater underemployment than at any time in the past eight years; in the year ending February 1971, the payments made by the Wage Equalisation Fund almost doubled. Unemployment also appears to be rising, on the basis of the lists of job-seekers, who have increased by one-fifth during the same period. As to wages, a sharp rise in hourly rates, with its repercussions on the cost of labour, is at present accompanied by only a modest increase in income, owing to the reduction in working hours and the virtual stagnation of employment.

As for domestic supply, in view of the fact that the national product in the last quarter of 1970 was less than 1 per cent above the average for the year, it would be necessary, in order the achieve an increase of 4 per cent at constant prices, for it to go up at an average quarterly rate of about 1.5 per cent. This does not seem to be happening; industrial output, the trend of which, directly or indirectly, largely determines that of the national product, shows, seasonally adjusted, a decline of 1 per cent between the fourth quarter of 1970 and the first quarter of 1971.

Labour productivity, as a result of the trends of production and employment just described, is still far from resuming the upward trend which is an essential condition for bringing the Italian economy back into line with its development potential.

Confirmation of these difficulties is to be found in the trend both of bank lending, which is not expanding to the extent allowed by the greater creation of monetary base, giving rise to an increase in bank liquidity, and of prices, which are still rising under the influence of cost increases. It should be added that the replacement of the turnover tax by the value added tax may superimpose further expansionary pressures on the upward spiraling of prices caused by costs, as experience in other countries has shown. If the price increases are concentrated in sectors closer to the final consumer, intermediation activities will benefit, while the position of manufacturing enterprises will be further aggravated by the consequences which, through the sliding-scale mechanisms, will be reflected in costs.

Lastly, foreign trade in goods and services, after an improvement in the latter part of 1970, showed in the first quarter of the current year, seasonally adjusted, a deterioration of the balance, which has swung round to a deficit.

The signs of slacker economic activity – despite the much faster growth of the budget deficit than had been indicated – seem to confirm that the rise in private investment is slowing down. On the other hand, the increased deficit of the public sector, if it helps to give fresh impetus to activity in those sectors where demand has contracted, might contribute to keeping the volume of output at higher levels than can be achieved if nothing is done to stimulate production.

However, although the current economic trend necessitates a large public-sector deficit this year, the additional expenditure should be of a kind that can be promptly restrained as soon as the pace of overall demand shows signs of recovering.

The proposed measures for shifting certain social charges from employers to the government and the refund of the turnover tax on industrial investment meet this requirement. The calculations carried out jointly by the economic planning bodies and the Bank of Italy show that no inflationary effects will be produced if the measures bring about the expected increases in output and if the growth in financial assets is compatible with these; but the result will be a greater rigidity in our economy's financial structure.

The existence of a high level of foreign exchange reserves enables this policy to be pursued, since there is a fairly good margin to cover the effects of possible mistakes in forecasting. In 1964 it was the foreign component that sustained demand; this time it might be public expenditure. If this were to lead to increases in total expenditure in excess of the immediate possibilities of supply, the temporary adverse effect on the balance of payments ought not to give rise to concern.

It may be wondered, however, whether support should be lent to actions which first depress the economy and then stimulate it through measures which, even when they are successful, do not eliminate the jerky nature of the development process. It is this stop-go tendency that causes a contraction of investment, which inevitably impairs the continuity of development. Determination of the trend of incomes within the framework of a planning policy reached with the help of both employers and employees is the right solution to ensure a smooth and steady growth of income.

With the same objects in view it will be necessary, when the Programme for the five-year period 1971-1975 is drawn up, that the enormous financial requirements arising from the implementation of the reforms, or from other laws before Parliament or in course of preparation, should be scrutinized to ensure their compatibility with those of the other sectors of our economy, within the framework of an overall picture of the available resources and their uses.

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Our increasing participation in an enlarged and ever more deeply integrated European Economic Community is taking place at a time when our economy is hampered in its growth by a cost and price structure which discourages capital formation and by a structure of public expenditure which does little to assist it, while the changes connected with the introduction of certain reforms in our economic system create uncertainties which are reflected in the behaviour of businessmen.

Our economy has suffered a wound, and neither the stimulus from public expenditure, even if orientated in the most suitable directions, nor credit expansion, however boldly undertaken, will alone serve to restore its vigour. It will be necessary, for a certain period of time, to achieve productivity increases in ways compatible with the more advanced systems that it is intended to introduce into business management and working conditions, and always proportional to wage increases, with the object of reducing the discrepancy which has developed between our country and our competitors in the movement of labour costs per unit of output. If this does not occur, we shall be obliged to accept inadequate rates of growth.

The decadence of the sense of social discipline, in Italy and the rest of the world, has created a situation in which groups possessing sufficient power take action to gain larger shares of income, thus imposing the acceptance of rising prices. Under these conditions, the monetary authorities have no choice but to feed the expenditure circuit to the extent necessary to finance transactions that are carried out at continually higher prices. Equilibrium is restored by inflation or by excluding the weakest from the process of wealth creation, or by a combination of both ways. Neither fiscal policy, nor monetary policy, nor a skilful policy mix can eliminate the evils from which society suffers when individuals do not consider themselves bound to a community, as parties cooperating in it, deriving their value from the work they perform in it and from the cohesion it achieves in freedom.

We are firmly convinced that the introduction and implementation of the reforms program, a fascinating and arduous task for this and the next few years, will be crowned with success if we can draw inspiration from this need for a renewal of harmonious cooperation. Another task also awaits us: that of completing the process of lasting integration of our economy into the system of more advanced countries, where tensions exist similar to those to which our country is subject. The younger generation of entrepreneurs and managers must be willing to persevere under more complex conditions than were known by their older colleagues, and this will subject their creative abilities to harder tests, but not such – this is our hope and is also indicated by the signs around us – as to prevent those abilities from being exercised.

We, as the intermediaries between the sources of savings and production, are faced, and will continue to be faced, by difficult choices in the guidance of monetary flows. The purpose of our action will be, as it has been in the past, to hasten economic advance within a framework of social progress.