Concluding Remarks for 1971

The United States' New Economic Policy, the Monetary Crisis and its Repercussions on Italy

During the past ten years, we have devoted the introduction of the concluding remarks of our Report to the international monetary system, to its functioning and to proposals for its reform. The sequence of intervening events has not compromised the continuity of the views we have advanced in the conviction that it is impossible to restore order to a system wherein co-ordination of the economic policies of individual countries should be conditioned by their acceptance of the constraints imposed by the relationship between variations in international and domestic liquidity. We have also contributed to the discussion on the introduction of reserve instruments which could isolate the creation of international liquidity from the vicissitudes of the United States' balance of payments and from the flow of newly produced gold into the monetary system.

Over the years, we have been increasingly insistent in our warnings regarding the possibility that the dollar might be declared inconvertible and we have emphasized that the rest of the world should be ready with its response. In 1968, we suggested that the European Economic Community's response should be to transform itself into a monetary area, with fixed parities between the member countries' currencies, which should however be allowed to fluctuate vis-à-vis the dollar and dollar-area currencies. Three factors have combined to hinder a transformation of this kind: first, insufficient progress towards the establishment of homogeneous regulations relating to joint-stock companies, to stock exchanges, to the banking system and to direct and indirect taxation, especially regarding income from securities; second, the unsatisfactory implementation of Community policies concerning anticyclical measures, regional development, agricultural structures and technological progress; and third, the divergent interpretation of the measures taken by the US government and of the international monetary consequences arising from the new economic policy embarked upon by the United States. It is perhaps relevant to add that on both sides of the Atlantic restoration of the international monetary system is often viewed as a return to the conditions of yesteryear, like the nostalgia to revisit a once familiar haunt.

At the beginning of 1971, the US government seemed to be moved by the conviction that recourse to appropriate fiscal and monetary policies would stimulate a sufficiently large increase in supply to contain inflation: but the course of events demonstrated that the situation in which the economy was heading would not enable reconciliation of the objectives of faster growth and higher employment with the goals of greater price stability and improved balance-of-payments equilibrium. The measures intended to expand demand, and thereby to stimulate growth, produced little effect on the level of employment, but they had immediate repercussions on price levels, while the balance-of-payments deficit was increasing, despite a mounting reluctance on the part of the rest of the world to hold dollars. These contradictions, which cannot be explained by conventional economic reasoning, also prompted the decision to free the US economy from the constraint exercised by the balance of payments both by promoting the idea of currency realignment, with the object of diminishing the disequilibria, and, perhaps above all, by suspending convertibility of the dollar into other reserve instruments.

Towards the middle of 1971, the United States economy was marked by the persistence of a high level of unemployment that seemed to react only momentarily to increases in demand. It was considered urgent to adapt the financial structures to the new economic situation so they could better transmit the stimuli imparted by monetary policy: there was also a call for fiscal policy based on the principle of containing public expenditure within the limits of the volume of revenue which would accrue to the government in a situation of full employment. But, at the same time, there was the widespread conviction that a policy of this kind would be ineffective unless implemented within the framework of an incomes policy backed by more than exhortations. The projected policy would be carried out in the form of public interventions designed to orient, rather than oppose, market forces. But this would be impossible without the action of new bodies in which management, labour and government were represented. The conditions for success of the policy, it was concluded, lay in convincing the public of the need for a planned economic policy and in the readiness of the Administration to devise the policy through self-executing rules, concentrated in key sectors.

Study of the observable and foreseeable structural changes in the economy proceeded, but in the meantime the US Administration could not escape from the need to resolve the serious problems stemming from the considerable under-utilisation of productive capacity.

The Federal budget presented in early 1972 indicates the general lines of the strategy on which the new policy is based: expansion of aggregate demand through the manoeuvre of public expenditure; increase of the budget deficit covered by securities issues; accelerated growth rate of the stock of money and quasi-money; and containment of wages and salaries, prices and profits by means of a kind of incomes policy. This strategy rejects the concept that the function of the monetary authorities should be limited to regulation of the money supply, leaving market forces to adjust real magnitudes to changes in its quantity. The US Administration has not failed to warn that the balance of payments may continue in deficit for the next two years, thereby heightening existing tensions on foreign exchange markets.

We feel it is opportune at this point to examine briefly the factors which explain the effectiveness displayed, in recent months, by the policy of expanding public expenditure in order to increase national income.

During 1971, wages and salaries rose faster than productivity, but the increase in unit costs was followed by an even higher rise in prices; as a result, the enterprises disposed of greater liquidity, thereby recreating one of the necessary conditions for the revival of their propensity to invest. During the third quarter, the financial resources of the enterprises rose at an annual rate of 130 billion dollars, of which internal resources accounted for 72 billion. In a situation of this kind, the increase in demand induced by public expenditure was bound to intersect with expanding supply; and similarly, the climate was right for an expansion of investment. This explains the success of the fiscal policy, freed from the fear that demand might negatively influence the balance-of-payments equilibrium.

Inconvertibility of the dollar, together with the parity realignment of December 18, 1971, have contributed to the emergence of a monetary arrangement consistent with an economic policy which has become even more intolerant of the external equilibrium constraint. Increasingly insistent authoritative voices are being raised to warn that return to convertibility of the dollar would transfer the power to influence the management of US economic policy to the monetary authorities of the rest of the world. The United States, it is argued, should not undertake commitments of this nature: it would not be possible to fulfill them; and the final consequence might be resort to restrictions on trade and payments. In this context, it is difficult to comprehend the economic logic linking the declaration of official parity of the dollar and the declaration of the parities of the other currencies if, at the same time, there is no return to some form of convertibility of the dollar.

After the Washington conference, it was stated that there would be a large flow of dollars from the central banks to the private sector and from both those sources to the United States; it was said that there would thus be an improvement of the US balance of payments both on official transactions and on liquidity basis. But this has not occurred; in the first quarter of this year, the Group of Ten countries together purchased approximately 2 billion dollars. During that period, Italy sold 400 million.

This situation served to strengthen the conviction that the European Economic Community should be transformed into a monetary area, with its own individual status in the framework of the international monetary system. Following a decision reached by the EEC Council of Ministers, it was established that as of April 24, 1972 the margins of fluctuation of Community currencies around their official rates may not exceed 2.25 per cent, instead of the 4.50 per cent margin which would result from implementation of the maximum limit of fluctuations with respect to the dollar permitted by present agreement (+2.25 per cent). Interventions in Community currencies are obligatory in order to keep the respective quotations within the narrowed fluctuation band, while it was established that intervention in dollars is permitted only when quotations of that currency reach the prescribed maximum limits. Within the respective fluctuation bands (the narrower relating to EEC curriences, the broader to rates between those currencies and the dollar), intervention may occur only after a concerted decision among the EEC central banks. To enable intervention in Community currencies, provision is made for the granting of swaps between the central banks of the member countries. Debtor positions so incurred must be settled first by utilising any holding of the creditor country's currency, and then in gold or gold-convertible instruments (SDRs, credits with IMF) and in dollars or other currencies, in proportion to the holdings thereof in the official reserves of the debtor country.

Application of this system will have far-reaching consequences. A monetary order of this type will mean that the quotation of the dollar in Community currencies reaches the intervention limits in relation to the global surplus or deficit of the Community taken as a whole: the volume of settlements in dollars will be equivalent to that surplus or deficit, and settlement will be effected by Community countries having a net global surplus or deficit on balance of payments, and therefore with more appreciated or depreciated currencies.

Variations in the dollar reserves of these countries will be equivalent to the net surplus or deficit of the Community with the rest of the world and to the amount of intra-Community balances settled in dollars. Within the Community, the creditor country may, with the consent of the debtor country, continue to hold the currency of the latter, instead of requesting settlement. Within these limits, the difference between the global surplus of the creditor country and the global surplus with the rest of the world (in this case, the surplus with the other Community countries) will be settled through the purchase of Community currencies. To the extent in which this occurs and the greater the weight of intra-Community settlements, a monetary system will be created wherein the composition of reserves will tend, on the one hand, to include a higher proportion of Community currencies and, on the other, to become more homogeneous. This will facilitate the transfer of reserves to a centralised organisation which would have the status initially of a monetary co-operation fund and subsequently of a federal bank.

It is clear that the survival of this system will depend on the extent to which it is exposed to the tensions which the international monetary system has been subjected to as a consequence of the divergencies between the cyclical trends of the major industrial countries and of differences in their economic and monetary policies. We have repeatedly affirmed that the problem facing the Community can be solved only by accelerating the process of unification of the institutions within which economic activity is carried out, and by speeding up co-ordination of targets and of the policies framed to attain those targets. There is insufficient evidence to suggest that solution of these problems is near; nevertheless, while the search for the most suitable solutions continues, there should be no delay in defining a common policy of relationships with external areas, in order to shelter Community markets from the deflationary or inflationary pressures originating therefrom.

But the degree of interdependence of financial markets does not permit delimitation of the border between the national market and the international market, in which transactions are settled in dollars and in other currencies; these, in fact, have become almost sections of a single market. The greater the possibility of transferring funds from one to the other on the basis of fixed exchange rates, the greater the need for authorities to subject the two sections of the market to uniform regulation. The necessity of imposing controls on flows of dollar funds into national markets is underlined by the fact that these flows have become more independent of the US basic balance-of-payments position, and even more so of that country's current account balance. An excess of such flows generates distortive effects on the real sector, both because it affects credit policies within individual countries and because it tends to widen exchange-rate variations.

Statistically, the effects of transfers of dollar funds from the private sector to central banks, and vice versa, are manifested in negative and positive changes, respectively, in the US balance of payments on official transactions, always provided that such funds are deposited in the United States. The size of transfers from one sector of the market to the other is influenced by expectations of changes in parity and by interest rates, but their weight increases in importance with the volume of dollars held by non-residents, and this, in turn, is determined by the balance-of-payments deficit on liquidity basis and by the volume of Euro-bank assets. The dimension of the Euro-dollar market is influenced by the amount of liquid funds held by Euro-banks in the United States and, likewise, also by the amount held by those banks in national currencies, when there is the possibility of converting them into dollars on the basis of fixed exchange rates.

On previous occasions, we have discussed the credit multiplier effects which occur on this market: the broadening of our knowledge demonstrates the need, in order accurately to measure this phenomenon, to take account of variables which have acquired some importance in the recent past. When the same constraints are not applied to both, the co-existence of two contiguous markets – one in dollars and the other in national currencies – induces operators to utilise the market not subject to limitations imposed by the authorities when meeting their requirements. Thus, the idea of introducing in the Euro-dollar market compulsory reserve coefficients, similar to those applied to local banks, appears to be well-founded; in other words, it is necessary to regulate the banks' capability of offering credit in dollars.

The abundance, and the inconvertibility, of the dollar is prompting some central banks to resort to conversion of dollars into other currencies. Of late, increasing proportions of the reserves of some countries have been switched into pound sterling, Deutsche Mark, Swiss francs and guilders. Deposits of these currencies in countries other than the issuing country can produce international liquidity multiplier effects similar to those generated by central-bank dollar deposits in the Euromarket. It would therefore be advantageous if diversification of reserves and their employment were mutually agreed upon by the central banks.

In the absence of effective regulation, the volume of flows of undesired funds could be of such magnitude as to present problems similar to those faced by the Europeans in 1971: a year in which exchange rates between the various currencies were subjected to pressures exercised by abnormally heavy short-term capital movements.

In studying the consequences, consideration must be given to the competitive trading position that the Community countries intend to maintain with the United States. During the 1950s and part of the 1960s, the United States enjoyed a virtually monopolistic position for certain goods, by virtue of its greater innovative capability; but the spread of know-how in the manufacture of goods with a high technological content has weakened that position. The new products became available on local markets, also because US firms found it increasingly advantageous to manufacture abroad directly, thereby becoming more competitive both on foreign markets and on the home market. The importance of the price factor increased. In these circumstances, the establishment of adequate exchange rates between the dollar and the currencies of the other industrial countries assumes greater importance; and it becomes increasingly necessary to protect those rates from the consequences of flows of unwanted funds.

Despite the fact that the major countries to which these funds might flow state that they are prepared unconditionally to absorb dollars, in the absence of measures designed to contain such flows, doubts remain as to the feasibility of preserving a system based on fixed exchange rates. In a number of countries, measures have been taken wherein exporters are granted exchange guarantees: this has not been possible in Italy because of the interruption of Parliamentary activity; however, a decision should be taken quickly.

Short-term dollar claims on the United States at the end of 1971 amounted to 63.8 billion dollars, of which the central banks held 47.4 billion and commercial banks and private operators 16.4 billion. During the early months of 1972, the larger part of the US balance-of-payments deficit on liquidity basis was financed by purchases of dollars by central banks. The degree of stability of the international monetary system depends to a large extent on the propensity of the central banks to continue to hold the dollars they presently possess. So long as this propensity exists, the source of danger to stability will lie exclusively in the United States' balance of payments.

The widespread conviction that the monetary authorities are in favour of maintaining the present parities has prevented the recent increase in the price of gold from having any appreciable repercussions on foreign exchange markets. Indeed, the price of gold rose in a very limited market, where the pressure of demand, initially for industrial utilisations, encountered an almost complete absence of supply.

In the light of further US balance-of-payments deficits, the question arises as to which sector should absorb the newly created dollars: the commercial banks or central banks? If the dollar liquidity of the commercial banks were to rise, it would be necessary to take steps to prevent the consequent credit multiplier effects from reaching such proportions as to disrupt the domestic credit and monetary policies of individual countries. Those effects would probably be more controllable if the newly created dollars were acquired by central banks, even if a policy of this kind could not be pursued indefinitely. Hence the need to strengthen the European monetary area and to transform it into a centre of attraction for the largest possible aggregate of countries disposed to link their currencies, on the basis of fixed rates, to those of the European countries, thereby contributing to the creation of a system less exposed to destabilising pressures of external origin.

On various occasions, I have expressed doubts as to the feasibility of re-establishing an international monetary system based on the principle of universality: I continue to believe that the solution must be sought in the formation of large monetary areas. However, the majority of reformers seem to adhere to the very concept which inspired the gold-standard system; each proposes solutions based on the assumption of imposing settlements of debtor and creditor positions between countries through one instrument or another available in limited quantity. The proponents of these solutions appear to believe that the signatory countries would be prepared to accept the constraints inherent in that limitation. They are asked whether determination of the limit should be left to the wisdom of an international organisation which creates SDRs or to the restoration of gold's traditional function; bearing in mind that the yellow metal has proved to be, and would continue to be, an uncontrollable instrument causing fortuitous rises and falls in the value of other instruments, capable of creating distortions beyond the control of government action.

In reorganising the international monetary system, it will be necessary to recognise the profound change that has occurred in the balance of economic power between the United States, on the one hand, and the EEC and Japan on the other. Furthermore, it will be necessary to take into account the greater importance of the developing countries, especially those which produce the energy resources on which the Western industrialised nations are becoming increasingly dependent. The IMF, originally conceived as an organisation provided with wide regulatory powers, on the assumption that the economic power of the United States would enable implementation of its decisions, would instead become a forum for the reconciliation of the manifold interests of the regional groups. In performance of this function, the chances of success would be enhanced by the participation of the countries of the socialist area, which in some cases have displayed renewed interest in the problems concerning reform of the international monetary system. Awareness of the new situation is evidenced by the declared intention to assign negotiation of the problems associated with reform to a group of representatives of 20 countries, selected in such a way as to ensure more balanced representation of the interest of the various nations.

If it is assumed that the international monetary system should provide instruments for the settlement of international payments, designed to facilitate the process of adjustment between large aggregates – the United States, the European Economic Community, Japan, the oil-producing countries and the developing countries – it would follow that the principal function of reserves consisting of gold and SDRs should be essentially to control possible fluctuations in exchange rates between those large areas so that they reflect basic balance-of-payments patterns and do not undergo sudden variations caused by short-term capital movements. In addition, the desirability should be examined of the issuance of SDRs into which a proportion of dollars currently included in the reserves of the industrial countries could be converted, thereby emphasizing the willingness of the central banks holding those dollars not to cause their transference to the commercial banking circuit. It should also be noted that reserve requirements will diminish in line with the rate of economic integration: within the EEC swaps would perform, at least in part, the function currently assigned to reserves. Finally, the existing criterion of allocation of SDRs on the basis of quotas subscribed by each country to the IMF should be replaced by another, designed to ensure the flow of newly created SDRs to those countries most in need of new liquidity.

Turning now to the consequences of the international monetary crisis on the Italian economy, it should be stressed that the transition from the former parity of the lira to its new one occurred without serious complications. We did not consider it opportune to establish a two-tier market but instead operated on the level of external indebtedness, in line with the policy adopted regularly over the past ten years.

Indeed, since the first signs of the dollar crisis emerged, Italy has never been the target of serious speculative attack. Phenomena of this kind have been avoided above all by avail of the existing control mechanism: the institutional control requiring the banks to maintain their foreign exchange positions in balance; regulation of the banks' foreign operations; and management of the ceilings of foreign exchange granted by the Italian Foreign Exchange Office (in particular, the ceiling on forward operations). Observance by the banks of the obligation to maintain their external position more or less in balance has not meant a diminution of their intermediation activity; in that the position has been kept in balance at increasingly higher asset and liability levels, as evidenced by the fact that they rose from just over 20 billion dollars at the end of 1970 to approximately 26 billion at the end of March 1972. The control mechanisms have been reinforced whenever the international monetary crisis has heightened. But Italy has been isolated to some extent from speculative movements also by the less attractive prospects for placement of funds, due to the difficulties displayed by the economy and to the unpromising forecast as to its possible evolution.

During 1971, by acting on the procurement and repayments of loans, the authorities were able to keep capital movements, excluding commercial credit, in relative equilibrium. Of the other forms of capital export, banknote remittances gave rise to a net outflow equivalent to 893 million, at an average monthly rate fairly close to that of 1970. In anticipation of developments on foreign exchange markets, most of the loan agreements concluded since the last quarter of 1969 have contained a pre-payment clause. The usefulness of this clause was soon to be demonstrated when the sudden reversal of trend caused by the dollar crisis called for a change. Thus, as of July last year (when our dollar reserves, totalling 2.3 billion, were roughly equivalent to dollar liabilities accruing from the larger loans contracted in the preceding period of extensive resort to foreign capital) it has been possible to put the borrowing policy into reverse and to neutralise an inflow of dollars which would otherwise have resulted in holdings of that currency exceeding the amounts considered desirable at the time.

As the consequence of prepayment operations, the amount of such foreign loans outstanding had fallen to 750 million by March 31, 1972, when our dollar reserves amounted to 2,050 million. Since borrowers have repaid their loans at more favourable exchange rates than those obtained when they were contracted, they have benefitted to the extent of nearly 20 billion lire; the gain refers largely to prepayments by bodies in the public sector.

Between the end of 1970 and March 31 this year, Italy's net official reserves rose from 5,270 million dollars to 6,250 million: during that period the proportion of gold, unchanged in absolute value, fell from 52 per cent to 44 per cent of the total, explained by an intervening increase of reserves held in SDRs and in convertible currencies of the EEC countries (which later accounted for 20 per cent of the total on March 31, compared with 15 per cent at the end of 1970); the proportion of dollars remained at just under one-third of the total. Similar variations are observed in the reserves of the other Group of Ten countries. Italy is still one of the countries with the highest proportion of reserves in gold (44 per cent, as compared with the Netherlands' high of 47 per cent) and the lowest proportion in dollars. Japan, Canada, West Germany and the United Kingdom are the countries with relatively high proportions of dollars in their reserves, ranging from 73 per cent to 63 per cent of the total.

Within the EEC, owing also to the United Kingdom's entry, we saw a tightening of the links between enterprises and their associations, between trade unions, between banks, and between cultural movements. The pattern of unification is becoming clearer. The process is being constantly enriched by the effort of new men and by the contribution of new skills, but the process will be impoverished unless a political class, inspired by a common ideal, emerges to provide leadership for the business and commercial world. When questions arise calling for the intuition, the resoluteness and boldness required of politicians, their voices should prevail over those of the experts; otherwise the measures taken will suffer from abstractness and an impression of waning political vitality will become widespread. At the institutional level, the Council of Ministers should assert itself, in increasingly explicit terms, as the driving force of the Community.

But accelerated unification will unleash forces which, unless appropriately oriented, could inhibit the participation of important geographical areas and social groups in the development process. The progressive limitation of national autonomy in the areas of foreign trade, capital movements and credit policies and, in the final analysis, of global demand policy, could influence economic development favourably in some countries and regions, adversely in others. Therefore, alongside the mechanism of monetary unification, the timely preparation is required of the instruments of a policy for balanced growth, financed also from the centre. We are supported in this conviction by the historically recent experience of Italy's unification and by the awareness of the heavy burdens that have had to be borne, especially in the South, in the wake of economic unification left to free market forces. In this light, we believe that we are able to contribute to the understanding of the problems facing member countries as the integration process gains momentum, in the form of a description of some of the changes that occurred in Italy's economic and financial structures during the 1960s.

Changes in Economic and Financial Structures during the 1960s

Ten years have now passed since the founding of ENEL – the National Electric Energy Agency. Numerous debates preceded and followed this act which, at the time, seemed to be the most momentous of the structural transformations our country would undergo. On our part, we stressed that the creation of organisations which by their nature have more frequent recourse to the financial market, mainly in the form of specific types of securities, would pose serious problems. In addition, we underlined that the measures adopted in nationalising the electric power industry should be based on the requisite of allowing the monetary authorities to keep firm control of financial markets. However, we also clearly predicted that this move would exacerbate problems growing out of the needs of both public investment aimed at bolstering the infrastructures of an advanced society and of private investment beyond the enterprises' self-financing abilities, though the latter were still considerable then. In testimony before the Chamber of Deputies' Enquiry Committee, at its November 22, 1962 hearing on the limitations placed on competition in the economic field, I warned that we were heading towards a period in which far-reaching structural changes in our economy would certainly have repercussions on the ways of financing investment. The more the state turns its efforts towards implementing a policy of infrastructure development, I stated, the more it will become necessary to raise required resources in the financial markets. I went on to say that if development policy hinged on industrialisation, but at the same time we limited the companies' self-financing possibilities, it would become necessary to raise funds in the financial market by issuing securities and hence company shares. Otherwise, the special credit institutions, which raise capital through bonds, would have to be equipped to increase their lending activities. The greater the shift of income from the enterprises to the households, I pointed out, the greater the gain in importance of financial intermediation. Yet in this process an ever larger role is being given to bonds. No expedient could lure the public into placing their savings in these securities if the prospects seemed dim for reasonable monetary stability. Events during the 1960s bore out this interpretation. In this exposition I do not intend to give a detailed description of these events, but only to touch upon the major changes that took place and their causes, as these have repercussions on the economic and monetary policy decisions which the government authorities will have to make in the near future.

During the 1960s, the main features of our productive system underwent profound changes: notably, in the form of industrial concentration as the groups expanded, greater investment by the state-controlled companies as compared with the private ones, and the considerable dwindling of stock ownership by households. The passage from the old guard to the new was not always painless. In some cases, dynastic family capitalism was substituted by modern management structures. There has been a strong movement towards direct participation in the formation process of company decision-making, but it has often met with widespread incomprehension. The method of planned economic direction has given rise to a new category of public officials, but between these men and the conventional administrators a sort of wall of incommunicability has formed.

During the 1961-70 period, the economy's development process was bolstered, as in the previous decade, by the decisive contribution of the industrial sector. On average, the value added turned out by the manufacturing companies – which are the most representative and dynamic element in the entire sector – calculated at current prices, grew at the yearly rate of 7.2 per cent (vs. 7.8 per cent in the previous decade). Since the labour factor in the productive cycles, measured in terms of hours worked, held quite steady, yearly productivity trends were nearly identical to those of value added. This was achieved both by reorganising the companies' internal structure and by making the production process more capital-intensive and finally by the improved skills of the labour force. Stepped up productivity had its toll, particularly in heavier workloads. This, plus a lag in the development of social infrastructures, produced strains in the physical and mental well-being of the workers. Since the end of 1969, trade-union disputes have often focused on this situation, bringing about contracts which ensure improvement of production-line conditions. The greater participation of workers in decisions on production methods, while representing a step towards more modern forms of business management, also imply a slowdown in investment and productive activity. As a result, most enterprises have become less profitable. Thus, despite the existence of expansive policies, it is more difficult to re-equilibrate company financial structures undermined by increases in wage costs. In the end, the employment level suffers.

In the same decade, wage rises kept pace with, or outran, augments in productivity in most industries, though the latter varied widely from sector to sector. Wage dynamics, that is, developed independently of the degree of company efficiency, thereby causing unit labour costs to dovetail. The enterprises tried, albeit with only partial success, to defend their portion of income distribution by increasing prices within the limits allowed by conditions on domestic and international markets.

As a result, in the manufacturing sector, against an average yearly increase of 10.9 per cent in income for dependent labour, other incomes rose on average by 8.9 per cent. This shift in distribution and the greater reliance of the enterprises on external financing, as well as the difficulties met raising funds through stock offers, had their impact on the companies' financial structure. The ratio of risk capital to liabilities of all public and private enterprises operating in the overall economy, dropped from 47 per cent at the end of 1963 (the first year this information was made available) to 38 per cent at the end of 1970 – not taking into account the reduction in stock market prices – and to 32 per cent if this factor is also considered.

More detailed information is available over a longer span for a group of 200 large public and private manufacturing enterprises. For these enterprises, between the end of 1958 and the end of 1970, the ratio of debts to total liabilities rose sharply. The trend was particularly intense during the first five years of the period considered when investment was developing considerably, but it hardly slackened in the following years when the let-up in investment should have allowed the balance to swing back. As a matter of fact, it moved from 36.1 per cent in 1958 to 42.9 per cent in 1963 and to 46.7 in 1970.

Within this overall pattern, the public and private enterprises showed different trends, especially over the last few years. In fact, the degree of indebtedness not only appears to be structurally higher for public enterprises, but from 1963 to 1970 it grew much more than did the private enterprises.

These differences can be explained by the private companies' generally stricter need to maintain balanced financial structures, and by the level of gross profits per capital unit. This level was lower for public enterprises. Too low in fact, in a large number of cases, to allow the replacement of fixed assets within their economic life span.

Another indicator of the enterprises' financial structure, the trend of the ratio of the companies' risk capital to the total of their non-liquid assets, is the source of even more glaring proof of the two groups' different debt policies. In fact, for the public companies between 1963 and 1970, this ratio lowered 15 percentage points while for the private ones it dropped 3. However, it should be remembered that the state-controlled productive companies took advantage of financing from their administering agencies, which in turn received grants from the Treasury.

Faced with the reduction in the relative weight of their risk capital and having exceeded the desired degree of indebtedness, companies attempt to react with larger stock issues; but the flotation cost increases with the deterioration of the financial situation, just as loan interest rates rise whenever the degree of indebtedness exceeds critical levels. A company cannot therefore depart for long from the desired structure of liabilities without being penalised in terms of higher costs of equity capital as well as of debt. In the extreme case when the degree of risk rises above certain limits, the sources of external financing may even dry up.

During the past three years, there has in fact been a rise in share issues, stimulated by fiscal concessions: but the degree of indebtedness has risen further, not only in the case of public enterprises, which have accelerated their investment programmes, but also in the case of private enterprises, despite the fact that the level of their investments has fallen sharply.

Between 1959 and 1963, a period of rapid economic growth, the earnings of enterprises were running at a high level, as were their borrowings. Firms were spurred to borrow by the advantage of increasing in this way their aggregate assets, with a consequently larger return on their own capital as compared to that on the overall invested capital. Subsequently, with the change in economic conditions, and when enterprises found themselves heavily indebted, also because they had reached the end of a period of large investment, the situation was reversed: the decline of profits caused a proportionally larger fall of the return on the firms' own capital than on aggregate assets, thereby contributing to hinder new stock issues. The limitations on raising risk capital, together with the lower level of enterprises' savings resulted in a containment of the firms' equity capital expansion; thus, at parity of other factors, a situation was created which restricted the borrowing ability of enterprises and, eventually, hindered their growth. For these reasons it is possible to speak, on the one hand, of cumulative effects of profits on the development of enterprises and, on the other, of destabilising effects of high degrees of indebtedness. In a situation of continuing high degrees of indebtedness it is by no means incidental that enterprises might find themselves close to bankruptcy, and either seek rescue from the public authorities or sell out to foreign companies.

As regards stock investors, during the 1960s a number of factors contributed to the deterioration of the tax position of shareholders: the introduction of the new system for recording share ownership, and the withholding of tax on profits distributed by companies; the increase of the tax rate on company profits; the increase in personal income tax rates; the introduction of a number of surtaxes; and the heavier burden of these progressive taxes as a result of increases in monetary income connected with the erosion of the real value of money. Taxes on interests paid on financial investment also increased: in the case of bond-holders, however, these taxes would seem to have had little disincentive effect, both because they are borne by issuers and because income from interest on bonds is in fact not taxed on a personal basis, since bond certificates are payable to the bearer. The average, as well as the marginal, incidence of taxation on personal incomes have been increasing throughout the decade under review, but they will diminish when the tax reform legislation comes into force. This will result in greater availability of savings for investment and a smaller overall incidence of personal taxation on investment incomes. However, since company profits will continue to be subject to double taxation, levied on both the company and the shareholder, the heavy overall tax burden borne by the latter will remain. The Italian tax system will continue to be more burdensome than in other countries, where shareholders are allowed a tax credit on dividends, enabling them to recover all or part of the tax paid by companies on distributed profits. Bond interest will be subject to a substitutive tax whose payment has to be obligatorily recovered by the issuer from the bond-holder, if a physical person. However, as a consequence of the shift mechanism, the tax will result in an additional cost for the bond issuer.

The aforementioned concentration process, which characterised Italian industry during the 1960s, gained impetus from the expansion of market dimensions and from fiscal concessions: the process was further accelerated, sometimes excessively, by the difficulties encountered by numerous, mainly medium-sized and small, enterprises. In the case of an extensive group of manufacturing companies, the phenomenon emerged in the first half of the 1960s and subsequently gained momentum: of the 784 companies comprising the group considered in 1958, only 423 remained in 1970. The increased industrial concentration, if calculated in terms of fixed capital, was attributable not only to the acquisition of smaller enterprises, but also to a stepping-up of investment by larger enterprises. State-controlled enterprises and private enterprises with a net worth exceeding 20 billion lire increased their fixed capital more than other firms. In this respect, the incidence of larger companies rose from 64.4 per cent in 1961 to 68.7 per cent in 1970. Firms' asset composition shows that, of non-liquid assets, the part representing investments in other firms has been increasing at a higher rate in the case of private than of public enterprises. This fact testifies to the expansion of the concentration process and the reluctance of private enterprises to undertake the risks of direct real investment. The increased weight of the larger enterprises is also due to the extension of their ties with smaller enterprises in the form of sub-contracting; in this way, the smaller enterprises preserve their individual status, but their negotiating power is diminished and, ultimately, they lose their autonomy.

The major transformation which occurred in the structure of the Italian economy is evidenced by the change in the proportion of gross fixed-asset investment in industry by private enterprises and public enterprises, the latter category including public agencies such as ENEL and state-controlled companies. The private enterprises' share of gross fixed-asset investment in industry has fallen from 81.1 per cent in 1961 to 52.8 per cent in 1971. These different percentage figures, although reflecting the different economic conditions in the two years under consideration, are such as to confirm the aforementioned structural change.

In our Report for the financial year 1965, reference was made to the expansion of investment in basic industries by state-controlled enterprises and, on that occasion, we stressed the desirability of intensifying public intervention in sectors concerning services of an infrastructural character and in sectors concerned with rationalisation of structures complementary to agricultural production. Doubts were expressed, instead, as to the desirability of state-controlled companies entering into competition with private enterprise in other sectors, with the result of upsetting the bases of corporate economic strategy of the private sector. Instead, the necessary infrastructures have not been created and the expansion of public intervention in the productive sector did not take place within the framework of a general strategy defining the objectives, limits and methods of public intervention; with the result that the structure of the industrial system has changed, to a certain extent, under the pressure of cyclical factors.

A far-reaching transformation has occurred also in the area of financial intermediation. The ratio of domestic lending by special credit institutions to that by commercial banks has risen from 46.9 per cent in 1961 to 62.1 per cent in 1971: during that period, the average annual growth-rate was 17.0 per cent for the former and 13.8 per cent for the latter. Of the total amount of funds lent by credit institutions to industry and for public works, subsidised-interest loans accounted for 48.0 per cent in the period 1961-65 and for 57.7 per cent in the period 1966-71. There has thus been a continuous expansion of the area in which the granting of loans is the result of the decisions of both the authorities that grant the subsidy and the institutions that conclude the loan operation. However, there has been an ever-growing tendency for the decisional weight of the former to prevail over that of the latter.

The granting of subsidies has become an integral part of economic planning policy. These subsidies are established according to the procedures concerning investment planning through joint government and enterprise negotiation, in conformity with the provisions of legislation relating to public intervention in Southern Italy. It appears increasingly clear that, in practice, the possibility of an autonomous evaluation on the part of credit institutions is conditioned by prior decisions of the planning organs. The margin of discretionary power granted to credit istitutions is steadily diminishing with regard to applicants for loans which have already received the declaration of conformity expressed by the Minister for Special Intervention in Southern Italy after technical investigation. If credit institutions were to be excluded from participating in the planning offices' decision-making process, they would eventually become merely administrative organs, with the sole function of verifying that disbursement of loaned funds proceeds in accordance with the progress of financed works. Entire productive sectors will have to be critically reviewed and the firms' structures re-examined; also for these purposes, the credit institutions could provide valuable collaboration.

As the granting of subsidies increases, the need for their coordination in a general investment plan becomes more urgent. This rationale underlies the provisions contained in the law for financing the Cassa per il Mezzogiorno – Southern Italy Development Agency – for the period 1971-75 inclusive. According to this law, companies having stock-exchange listing and those with not less than 5 billion lire of stock capital are required to notify the Budget Minister of their investment programmes relating to any part of the country. This requirement also applies to all firms (even if they do not come within the aforementioned categories) that intend to build new industrial plants, or to expand existing plants, for an amount exceeding 7 billion lire. It is CIPE – Interministerial Committee for Economic Planning – that has to decide whether the investment projects comply with national economic planning guidelines, in relation to the level of congestion in the projected areas of plant location, as well as to the availability of labour in those areas.

The above-mentioned law attributes powers regarding authorisation of gross fixed-asset investment which further extend the already wide powers under existing legislation. Leaving aside public intervention at the investment authorisation stage, the public sector, if we include public enterprises and state-controlled companies, accounted for 46 per cent of total gross fixed-asset investment realised in 1971, exclusive of investment in housing. Moreover, a large proportion of private investment is also subject to public intervention, in the form of granting subsidies. Under the new law, as a consequence only of the provisions relating to the amount of stock capital and to stock-exchange listing, approximately one half of the investments carried out by companies will be subjected to direct government control.

It is worth adding that the introduction of constraints on the investment plans undertaken by certain companies might induce them to have these investment projects implemented by their associates not covered by the control provisions; or it might generate a tendency to break down programmes into smaller parts. Even investments performed in these ways could be controlled if they were subjected to qualitative credit control. However, the economy would be deprived of a residual area more directly sensitive to market forces, an area which could serve as an indicator for the planners. The final result might be a system over-identified and more exposed to the danger of immobility. When, as in the case of Italy, there exists a wide area of direct and indirect controls on investment, it does not seem convenient to restrict the margin allowed on decisions concerning the granting of ordinary credit. We therefore reaffirm our conviction that a qualitative control on ordinary credit would be both superfluous and inefficient.

The recently introduced collaboration between planning organs, enterprises and special credit institutions seems bound in time to define a new method for the promotion of initiatives, for the selection of men capable of undertaking them, and for controlling that the means correspond to the ends and that the latter are finally attained. The overall system will be viable to the extent that it will be possible to prevent its degradation into another system wherein responsibilities fade out and it is sought to re-establish them by resorting to administrative and judicial controls. The efficiency of the overall system will be enhanced through decision decentralisation on a regional basis, provided that the competence areas of the central government and of the regional authorities are not violated. As observed by the Constitutional Court, the power to control credit activity and to supervise credit institutions must remain unitary, that is to say, it must be in the hands of the state. The credit function, in all its aspects, is a matter of public interest and must be subjected to a rigorously unitary discipline. In this matter the powers of the regions cannot exclude those conferred by law upon the state. Monetary order must be ensured on a national basis, in order to guarantee the flow of available resources into the various parts of the country and, consequently, to ensure balanced regional development.

The foregoing observations are based on the study of considerable statistical information. They obviously cannot be considered as definitive, but they do allow some conclusions to be drawn with respect to the country's general problems. It should first be emphasized that the growing awareness of the deterioration of the natural environment, and of its social consequences, seems to have created the conviction that public intervention is necessary in the capital accumulation process, in such manner as to regulate the territorial distribution of capital and its composition. The external diseconomies of certain investments, whether arising from their geographical location or from the production system employed or from the products manufactured, have faced legislators and planners with a number of substantially new problems. The aforementioned changes in economic and social structures, as well as in regulations, did not reflect those needs. Rather, the belief prevailed that the inclusion of productive activities in a state-controlled enterprise system would, *per se*, free them from the constraints imposed upon the management of enterprises whose survival is tied to the degree of their efficiency. The public sector has been endowed with a larger number of instruments suitable for stimulating production aimed at satisfying individual consumption, but not those of the community as a whole. The planners have not failed to proclaim that the public sector should orient its intervention towards planning by objectives. *Public investment, public consumption, social uses of income*: these are the logical categories to which it has proved difficult to associate public expenditures which have instead been determined by contingent requirements. The government has been provided with wider discretionary powers, but this has occurred in a still conventional framework, in which the problems of simplifying procedures and eliminating delays have not been dealt with.

The Financial Structure and the Control of Monetary Aggregates

The process of development of our economy within the European context greatly stresses the immediacy of those problems this country faces in regard to the laws regulating the corporate sector, the stock exchange and the rules of a competitive market. At present, with regard to this matter, there are several bills prepared either by the government or by Parliament. Moreover, these bills do not differ from each other in such a way as to require lengthy deliberation in order to achieve an overall agreement. If the productive system has to be based on independent firms organised along corporate lines, then the law must provide a suitable climate for their survival on the one hand and on the other clearly define their managers' responsibility and thereby protect the community's interest through the regular release of complete, readily comprehensible information. When the institutional structure has been brought up to modern standards, the power of the supervisory bodies to allow the listing of the stock of a corporation when it exceeds a given size or – as was cited in a Report some years ago – if it receives grants from the Budget, will not only bring added strength to our financial markets, but will also increase the effectiveness of supervision on the companies' behaviour and their development. The role which the stock exchange plays in the public interest would be performed with greater success if its intermediary activities were regulated by modern provisions. In this way it would be made clear that the stock exchange is not a place where few market participants waste funds representing the savings of others, but a forum where it is possible to give expression to investors' judgements stemming from a comparison between firms' financial means and their goals and results. Furthermore, the stock exchange should be viewed as a useful source of information, also for the central planning organs.

By setting up IMI – the Italian Industrial Credit Institute – the astute promoters of its founding Act intended, at a time of general economic depression, to provide new forms of intermediation. The statute allowed IMI to issue: special series of bonds linked to particular financial operations or groups of operations; bonds giving the right to participate in the dividends of certain groups of stocks held in its portfolio; and, finally, securities representing rights on special groups of public or private securities held in trust for the subscriber. These newly issued securities could take the form of registered securities or securities payable to the bearer. Thus, over the years repeated attempts have been made to integrate the forms of supplying capital by putting IMI in a position to take part in the creation of risk capital. These intentions, however, have met with little success owing to administrative obstacles.

Attempts to introduce modern legislation regarding mutual funds for investment in our country had the same fate. Certainly, at that time no one thought that this instrument would make any decisive contribution towards solving our financial problems; nonetheless, regardless of the possible outcome, it would have been better to try it. Administrative controls were set on the issuing in Italy of shares of foreign mutual funds and it was stipulated that at least half the stocks in their portofolios must be Italian. By December 31 last, the foreign mutual funds which are allowed to operate in Italy had sold about half a billion dollars' worth of shares: two-fifths of their market purchases were Italian stocks, foreign securities made up an equal portion and the remaining fifth took the form of liquid resources mainly deposited abroad. Only in the case of a fund authorised to place 5 million dollars of shares did losses arise owing to its difficult financial position.

In previous Reports, we have examined various aspects of our financial structure and in conclusion stressed the desirability of having institutions specialised in dealing with medium- and long-term credit and others specialised in short-term credit, although in certain cases it is difficult to mark a clear line between the point where one ends and the other begins. Since investment depends so highly upon external financing, especially in areas of intensive development, and since it is necessary to find new formulas for increasing financial market participation, it seems that the time has come to widen collaboration between the medium- and long-term credit institutions and banks, without excluding the possibility that one of the former might invest in the equity capital of the latter. Integration of authorised forms of fund raising by long-term credit institutions with others involving lower costs than bond issuing is needed; without, however, creating a level of competition between these institutions and the banks that might have an unfavourable impact on the cost of fund raising.

During the last decade, the banking system has not undergone any appreciable change as to its proprietorship-distribution between public and private sectors. By including within the first sector public law incorporated banks, savings banks, banks of national importance and the commercial banks under their control, namely the institutions whose top management is directly or indirectly appointed by the public authorities, it emerges that the sector's relative weight, calculated on the basis of amount of funds administered, rose to 66.7 per cent at the end of 1961 and to 67.8 per cent at the end of 1971. Within the second sector which includes the remaining banks a shift in favour of co-operative banks took place. Moreover, while the non-financial sector experienced an intensified process of enterprise mergers, bank concentration in terms of the quantity of resources administered by the larger banks was slower, notwithstanding the fact that the number of banks dropped from 1,261 to 1,158. It would be worthwhile to make a more detailed examination of the effects these divergent trends have on the efficiency of bank intermediation, especially with respect to the banks' attitude in directing enterprises towards more convenient financial decisions. Well sheltered from foreign competition, the system retains many oligopolistic features and operates in a market characterised by imperfections, some of which we will examine further on in this chapter.

More complete data, recently made available, on the banks' lending and deposit rates make it possible to weigh more accurately their attitude towards providing efficient services to the productive sectors and to transmit the impulses of monetary policy to the economy.

Data on bank lending and deposit rates refer to the last three years, notably a period in which bank activity was characterised by different phases. In 1969 and 1970, loans grew at a considerably higher rate than securities held in banks' portfolios: 15.1 and 10.2 per cent respectively in 1969 and 14.0 and 6.6 per cent in 1970. In 1971, the pattern was reversed: securities grew by 27.5 per cent and loans by 13.1 per cent. Indebtedness with the Bank of Italy, which increased in 1969, fell steeply in 1970 and hardly moved from these lower levels in 1971. Excess reserves shrank considerably during 1969 and in the first half of 1970; during the second half of 1970 and the first quarter of 1971 they rose rapidly, either in absolute value or with respect to deposits. Then they remained stable at the level reached at the end of March.

Although short, the period was rich in variations, hence the available data make it possible to analyse some features of our bank-rate system. The highest rates are paid by the local authorities that, anxious to obtain resources to finance their deficits, appear hardly sensitive to high credit cost. Next in line are the single-owner firms which, because their average size is smaller than other enterprises, are in a worse bargaining position. The rates paid by the companies are lower and are even more so when their shares are held by the state-controlled holding companies. The highest rates are paid by those industrial sectors where small enterprises are in the majority; while the lowest ones prevail in highly merged industries. Generally speaking, when loans are divided into groups according to amounts, their rates turn out to be inversely proportionate to their size. In terms of rate movement, the increase during the restrictive phase and the decrease during the expansive one were asymmetrical; whereas the increase, which started during the second half of 1969, coming to a halt towards the end of 1970, was quick to progress, the decrease, still going on, seems slower. Rates paid by the various sectors of the economy had a basically uniform movement during the growth phase. In contrast, during the decrease phase, rates paid by large public enterprises and those on the biggest loans declined more rapidly. Consequently, the spread between minimum and maximum rates, which was stable during the growth phase, widened considerably in the following phase.

The large banks, operating in highly competitive areas where customers are more sensitive to marginal differences on rates paid on deposits, immediately follow their competitors' lead when setting an increase. Thus, a competitive move by one bank is usually followed by a general increase in deposit rates – without substantial increases in the market shares of each bank – and with an increase in total deposits only in proportion to the ability of the banking system to attract more reserves by shifting the public from cash or Post Office deposits to bank deposits. Due to this type of competition, which quickly spreads rate increases offered by one bank over the entire system, the banks are slow to take the initiative of reducing deposit rates for fear of suffering losses in their market share. The increment in deposits which one bank can achieve by paying a higher rate is considerably lower than the loss of deposits that bank would suffer if it had unilaterally reduced its rate by the same amount. Since Post Office and bank deposits are readily interchangeable, even slight rate differences can cause large movements of funds from one category to another. The delay in adapting Post Office deposits to changed market conditions gives the banks the opportunity to temporarily divert funds from the Post Office administration during a restrictive phase, whereas during an expansive phase it forces them to be more cautious about reducing their deposit rates.

Against this background of imperfect competition, the interest rate and the volume of deposits are determined in harmony with the banks' earning assets, expansion and composition. Once lending rates have been determined as a function of the state of credit demand and supply and especially of bond yields, deposit rates tend to find their own level depending on the way each bank reconciles its goals of enlarging its market share and attaining high profits. The more a single bank is willing to sacrifice the second goal in favour of the first one, the narrower the spread between deposit rates and lending rates. Competition to defend and enlarge market shares while accelerating upward movements of deposit rates in a period when the latter are rising, tends, on the contrary, in a period of abundant liquidity, to hinder downward movements and, consequently, may delay the fall of lending rates. This implies that, in order to induce a downward movement in interest rates, it is necessary to increase the monetary base, in the expansionary phase, by an amount much larger in absolute terms than the decrease which is required in the contraction phase for the purpose of inducing an upward movement of the same magnitude.

In 1971, the annual average spread between lending and deposit rates was roughly similar to the previous year's and greater than that registered in those industrial countries where reliable information is available. However, it should be noted that international comparisons are of little value if not accompanied by information concerning taxes paid by the banking system. For instance, the Italian banks do not charge their customers for the payment of taxes on interest paid out on saving deposits. Therefore, they bear an added tax burden which eventually shows up in their profit and loss statements. Hence, if this circumstance is worked into comparisons, the difference between our country and the others does not seem so great. It must be added that banks operating in conditions such as those described earlier are subject to greater risks stemming from the enterprises' difficult conditions. Hence, it is in the general interest that banks keep sufficient reserve funds to protect depositors. Since the annual average spread between lending and deposit rates remained unchanged, the rise in banks' gross profits was the result of the huge increase in the volume of bank intermediation and the large number of securities subscriptions in 1971 as well as of the higher rate paid on compulsory reserves. The increase in the banks' balance-sheet total, which can be taken as an indicator of the volume of intermediation, was 14,000 billion lire in 1971 vs. 9,400 billion in 1970. The causes of an increment of these dimensions are: on the credit supply side, the volume of monetary base created by the Bank of Italy and, on the demand side, the public sector's large budget deficit (on an appropriation base).

During 1971, the Bank of Italy's policy as regards monetary and credit flow regulation made it possible to finance the public sector's deficit, which increased by 25 per cent over 1970, and to expand the flow of financing to the remaining sectors by circa 30 per cent. This huge change in the volume of financing was not matched by an increase in investments; but was partially used to cover the industrial sector's losses and, for the remainder, to restore ample liquidity margins in the business sector.

The creation of monetary base equalled 3,310 billion lire; subtracting the amount absorbed by the public, it caused an increase in bank reserves of 1,530 billion as compared with 1,170 in the previous year. Monetary base creation and the expansion of bank reserves were concentrated in the first months of the year. This was achieved, at the same time as foreign accounts were showing a surplus, by financing the Treasury's large deficit mainly through the central bank. Moreover, since the banks – which were almost free of debts to the Bank of Italy – did not have to make their usual start-of-the-year repayments, the resultant inflow of cash into the banking system brought about an equivalent increase in free deposits with the central bank.

The increase in bank reserves and the fact that this took place mainly at the beginning of the year led to a decrease in the banks' lending and deposit rates. Yields on long-term securities lowered to an even greater extent. This fall was nonetheless limited by the need to place sizeable issues of securities, designed to finance the government's and enterprises' deficits, in the banks' and public's portfolios.

Throughout the 1960s, trends in the bond market acquired an ever growing importance as a determining factor of the control policy on monetary aggregates. In fact, in an effort to enlarge the abovementioned market, the Bank of Italy gradually increased its intervention both on the market for newly placed securities and on the secondary market. In the aftermath of the summer 1969 bond market crisis, the monetary authorities decided to suspend the supply of government securities to the public. The capacity of the public's portfolios to absorb new issues was reserved for securities issued by the institutions which directly finance productive activities. Three different new-issue placement methods were adopted within the framework of this basic decision: in 1969, the rates offered were close to the market yield from similar securities already in the market; in 1970, they were set quite a bit below this level, and in 1971 they were put about 30-40 hundredths of a percentage point above it.

In the second half of 1969 and in January 1970, as bond prices fell, it was possible to place all the newly issued securities and to keep their impact on price to a minimum by issuing them at rates in line with market levels.

In the middle of 1970, with prices still falling, new issues at rates below market levels did not add negative pressure to the market's critical state; however, it was necessary to limit their quantity. In 1971, as prices rose, issues at rates above market yields made it possible to place large quantities of securities in the portfolios of the banking and non-banking sectors. However, they also had a dampening effect on the rise of bond prices and, indirectly, on the reduction of bank lending and deposit rates.

In sum, the policy pursued in order to influence new bond issues rates first cushioned the fall in prices and then later their rise. In both cases it worked on quantities: at first restrictively, then expansively. There seems to be no question that this policy made it possible to limit the negative impact of price fluctuations on the public's propensity to purchase securities. It could be argued that it would have been better, in a period when demand for goods was insufficient, to discourage household saving and thus pursue a policy aimed at a different distribution of securities between the non-banking and banking sectors. Our decision, instead, was to give utmost priority to the need to ensure continuity in the placement of securities with the households in order to finance public and private investments.

In 1971 the Bank of Italy intervened strongly in the markets in order to equalise yields on securities with a 6 and 7 per cent coupon. The net result of these operations, as well as of new issue purchases, brought about a rise of over 1,000 billion lire in the Bank's securities portfolio. During 1971, four issues of free ordinary Treasury bills were made in order to promote the creation of a portfolio of money market securities by the banks. Later, because priority was given to channelling the liquidity injected into the banking system towards loans, Treasury bill issues were suspended and those maturing were not renewed. With the same aim, monetary policy was directed towards shifting reserves from the central credit institutions to the banks and reducing the yield on them by eliminating the tied accounts with the Bank of Italy, excluding the eight-day ones whose rate, however, was reduced to 1 per cent.

The orderly functioning of the bond market might be hindered by the tax reform due to come into effect. As some authoritative commentators maintain, the most serious distortions will result from the fact that withholdings on bond yields will take the form of a final tax charge for natural persons and a provisional tax for juristic persons and will be set at different rates according to the category of issuers. Thus, for example, if 30 per cent is withheld, a bond issued at the gross interest rate of 8.57 per cent in order to ensure a 6 per cent net rate to the individual buyer will, instead, produce an 8.57 per cent yield for the juristic persons. Hence, the banks will find those issues with a higher withholding rate the most attractive. This means, in effect, that the indirect financial support the legislators wanted thereby to bestow upon some categories of issuers will instead work in the opposite direction. Hence, if the present composition of purchases of securities according to their categories is upheld, there might derive an upward pressure on bank lending rates and consequently on deposit rates.

It is the legislature's task to make the appropriate adjustments in view also of the need to bring our system into line with those of the other EEC countries if the country's aim, as still seems to be the case, is to move towards integration. Here at the Bank, our duties are more limited. In the present cyclical moment alongside the policy of expanding liquidity and channelling it towards those sectors of the banking system where it will have the most immediate effect, we have thought it wise to pursue a more clearly orientated policy as regards interest rates. With this goal in mind, we authorised new issues yielding rates lower than market yields and regulated our intervention on the secondary market in such a way as to reinforce expectations arising from this decision. However, we did not deem it appropriate to pursue the aim of stabilising securities rates up to the point where the volume of monetary base becomes a mere function of such a target. In any case, this policy was not followed without some uncertainties linked with expectations about the repercussions stemming from the proposed tax reform.

The acceptance by the public institutions of high borrowing rates has transformed this category into the main contributor to their banks' profit. The reduction of lending rates was in line with the liquidity control policy when the large-sized enterprises and especially the state-controlled ones were the loan recipients, but this did not apply to the smaller-sized firms. Credit granted to these enterprises can entail higher risks; therefore, it may be right that they are required to pay a higher rate as a sort of insurance premium. However, similar evaluation criteria of the economic conditions of the credit applicants do not apply to the large enterprises, and this holds even more when the latter are in the public sphere.

The presence on the same market of businessmen more or less aware of borrowing costs and with widely varying bargaining powers results in bank service price discrimination which induces sharper distortions in the economy. We must do the utmost within our authority to eliminate these market imperfections. Some people argue that, since these practices distort the price structure, it would be better to substitute market prices with a set of prices dictated by the authorities. Thus, they conclude, the authorities should fix bank lending and deposit rates and back them up with coercion. However, this policy, owing to other distortions it tends to create, is not in line with practices followed by the majority of the Western countries. Instead it seems preferable to try to re-establish equal conditions for all businessmen by providing the public with more information about the lending and deposit rates set by each bank. If this does not suffice to reduce the inequalities of treatment for the various categories of borrowers, it might prove useful to impose the maximum value of the spread between the highest and lowest lending rate applied by each bank. But we must not discount the possibility that the rigidity of such a spread eventually might bring about some credit rationing for those borrowers with a higher degree of insolvency risk.

Public Expenditure and Economic Revival

As we had occasion to stress last year, an analysis of the relationships between our economic system's labour cost and profit margins reveals that when sharp wage rises are not matched by increases in productivity added costs are not immediately shifted on to prices. This results in shrunken profit margins. Labour's added share of income has a direct, positive impact on consumption and a negative, albeit delayed, effect on investment. Hence, a redistribution of income towards the wage earners can stimulate overall demand in the short run. Shortly afterwards, however, the recessionary component represented by the slowdown of investment begins to take effect, as a consequence of the previous narrowing of profit margins. The final result of these contrasting forces on the volume of aggregate demand depends on the economic system's initial state and more specifically on: whether rises in unit costs have been completely offset by price increases in preceding phases, how large the shift in income distribution has been and how businessmen foresee the future demand trend. When the unit cost per man rises swiftly and in the presence of widespread uncertainty about the possibility of recouping funds put into production, then the recessionary components prevail and the fall-off in investment brings about a drop in demand and employment. At this point, it becomes necessary to enact an economic policy able to ensure the growth process' continuity and the public sector must expand its participation in income creation.

The expansive effects of public expenditure depend largely on its composition. The strongest income and employment results are caused by investment expenditure. A public sector which can quickly carry out investment programmes and rapidly increase the direct production of services can have an effective influence on demand.

Earlier in these remarks, we pointed out that in the United States, through the manoeuvring of public expenditure, the authorities succeeded in turning the economy around. In effect, they were able to foster the expansion of demand while the firms re-equilibrated their economic situation. It is worth considering why the marked increase in public expenditure which took place in our country did not produce its desired expansive effects.

Last year we asserted that public expenditure, appropriately directed and aided by an expansive credit policy, might have helped to prop up income. At the time, we stated that the existence of sizeable foreign currency reserves made this manoeuvre feasible inasmuch as it left ample room to cushion the consequences of eventual errors. Obviously, such reserves would be able to finance that portion of demand not met by domestic producers and resulting in a balance-of-payments deficit. Although, to the extent that this took place, the effectiveness of domestic demand policy would be correspondingly sapped. As it turned out, this was not the case; on the contrary, the balance of payments showed a widening surplus on current account. Thus, we must delve further to find out why the income circuit did not widen through the improvement of the firms' economic situation and the recovery of investment.

In 1971, the public administration made a considerable contribution to the growth of national income, partially making up for the effect of the private sector's behaviour. Augmented public expenditure, also bearing in mind tax leakages, brought about an increase in global demand large enough to produce a 3 per cent expansion in real terms of the GNP. However, income only rose by 1.4 per cent, owing to a decrease in some private sector demand components, notably investment in housing and inventories, as shown in this Report.

Higher proceeds from direct taxes and social security contributions were offset by greater outlays for social welfare and health services. This was because the population sharing in benefits increased, from this year onwards pensions were linked to the cost of living, greater unemployment benefits were paid out and the national health institutions partially repaid their debts. Indirect tax payments fell off as the economy went deeper into its downward spiral.

Demand support stemmed basically from increased public consumption expenditure, due almost entirely to rises in pay for state employees. Effective action in the investment sphere was instead lacking. Given the appreciable rises in prices, outlays were not large enough to avoid a drop in the volume of public investment as compared to that of the previous year.

Hence, public administration action was on the whole expansive but its composition was the least capable of fostering economic revival. Nor can it be stated that there was a strict relationship between decisions taken and their effects, since the expenditure increase was mainly the result of decisions made during prior periods.

We also asserted last year that neither the impulse of public expenditure, even in the most appropriate directions, nor credit expansion, even if boldly pursued, could have reinvigorated our economy unless increased wages were matched by boosted productivity that would narrow the gap that had opened between our country and its major competitors in terms of the growth of the cost of labour per unit of output.

During 1971, not only did this not come about but the previous year's wide disparity between costs and prices worsened. As a result, many firms floundered. The government came to their rescue by providing financial resources such as grants and subsidised loans, by setting up a new financial holding company GEPI (owned by the three state holding companies – IRI, ENI, EFIM – and by IMI) and through the activity of the existing state-controlled companies. In a situation characterised by soft spots in overall demand, some companies were able to make out well but even among those which were ably managed, many returned to involuted positions to seek out new equilibria. Productivity per man fell, while productivity per hour hardly augmented, thus bearing out the impossibility of productivity maintaining its medium-range trend, when the economic system is characterised by a sharp drop in the propensity to invest and a slowdown in work rhythms. As for the overall economy, the percentage of Italy's GNP invested in machinery and equipment remains the lowest within the EEC, with the exclusion of the United Kingdom and Ireland.

The slowdown in industrial investment which occurred in 1971 appears even more serious if we consider the opposite trends posted by the public and private sectors. The companies within the first sector, and especially the state-controlled ones, speeded up investment activity by 34.5 per cent (at current prices). The opposite took place in private enterprises; their gross fixed investments dropped by 7.9 per cent at current prices and by 17.0 per cent at constant prices. This behaviour is both cause and effect of the deterioration in the firms' economic situation. In the manufacturing sector, cost of labour per unit of output, which grew by 13.6 per cent in 1970, rose at roughly the same pace in 1971. Considering that few wage contracts expired during the year, the wage dynamic remained high. On average for the first three quarters, earnings rose by 16.6 per cent as the result of an increase of 26.1 per cent in the sectors where contracts were renewed and of 15.0 per cent in the others. In the latter, about two-thirds of the increase can be attributed to staggered rises written into previous contracts and to company-level settlements, while the rest depended on rises in the cost-of-living index.

Therefore, cost of labour per unit of output in the manufacturing industry rose by 28.8 per cent in two years while the prices of manufactured goods increased by 13.4 per cent. The size of this gap clearly differentiates the Italian situation from that of the other main industrial countries, where cost increases were more limited. In most countries, cost increments are fairly rapidly transferred to prices in relation to how quickly they take place, the market structure and the state of demand. The enterprises are prepared to live with temporary shrinkages in unit profits in order to achieve long-range goals. But in Italy the profit squeeze has gone beyond the bounds of a normal cyclical oscillation; or in geological parlance, the needle has jumped off the seismograph.

In terms of the overall economy, in 1971, the net national income at factor cost increased by 8.6 per cent while that portion of it ascribed to dependent labour rose by 13.4 per cent. The aggregate, which includes the income from unincorporated as well as retained profits, lowered by 1.7 per cent. We have not yet a breakdown of this figure, but in the reasonable hypothesis that the combined per capita income of enterprises remained at least unchanged in terms of purchasing power, then it follows that there has been practically no net saving on the part of the enterprises.

The situation in the industrial sector is somewhat worse. The net product at factor cost at current prices rose from 19,290 to 19,960 billion lire, that is by 670 billion. Wages and salaries and connected social security charges increased by 1,500 billion; this means that operating surplus has decreased by 830 billion. This reduction was focused, and most likely in an expanded form, on the enterprises' net saving, since it must be presumed that there was some increase in monetary terms in the other incomes' totals; i.e., payments for interest, dividends, corporate taxes and the combined income from unincorporated enterprises. Net enterprise saving, set at 860 billion in 1969 and 590 in 1970, can be estimated as having declined circa 400 billion lire in 1971.

This is a mean figure, around which the figures for the single enterprises show considerable dispersion. From released balance sheets, it emerges that a great number of firms finished in the red, although often the full extent of these losses was obscured. Indeed, not infrequently depreciation was calculated at lower amounts than necessary to fully replace consumed fixed capital. In no few instances, the enterprises had to dip into their reserves to pay out dividends. However, it is worth recalling that *reserves* is a book-keeping entry which includes portions of plants and equipment, machinery and inventories formed by the investment of company income over time. The tapping of reserves is equivalent, in economic terms, to using invested capital, thereby weakening the system's productive capacity in future years.

In sum, the enterprises produced less than in the preceding year and sold their output at unprofitable prices. The higher wages and salaries paid out by the enterprises, as well as by the public administration in the form of salaries and pensions, flowed back to the same enterprises, although at a proportionately lower level than in previous years owing to increased family savings, through the purchase of consumer goods and services. Most of these savings were channelled towards the enterprises through financial intermediation: not, however, to finance stepped-up investment, but to make up for the companies' insufficient saving. Thus, a complicated involutionary process was set in motion, whereby the equilibrium between investment and saving tends to settle at continually lower levels.

During recent debates, involving some politicians and economists, discussion centered around the possibility of intervention aimed at freeing our economy of the involutionary process presently stifling it. Reference was often made to the 1962-64 period and to the ways in which the crisis was tackled at the time. Experience gleaned back then is no doubt useful, although this time, even in comparable areas, the intensity of phenomena tends to be sharper. At that time the rise in costs was not high and the equilibrium of the companies' economic structure was not so threatened: the enterprises' net saving shrank but not below the plus-minus line and heavy investment in the years right before made possible increased productivity, thus paving the way for insertion into a rapidly expanding foreign trade flow. Hence, the firms were able to draw upon their own strength and foreign demand to re-equilibrate their financial structure. Government intervention made some contribution to further stimulating overall demand both by the Treasury's taking over part of social security contributions – a vital factor for the improvement of the enterprises' economic and financial situation – and by increased pension payments. The recessionary phase wore away, and after little more than a year industrial production was back up at the maximum levels reached during the pre-crisis period.

At present the situation is entirely different. In 1971, the public administration's contribution to income creation took on massive dimensions; this was coupled with a monetary policy already put on an expansive course in the previous year. The public sector's deficit, net of credit awarded to the private sector, rose to 4,300 billion lire from 3,450 in 1970 and financing to the remaining sectors of the economy, equal to 6,240 billion in 1970, rose to 7,980. By also taking into account investment by the public enterprises, and more specifically the state-controlled ones, propulsion provided by the public sector appears to be of unprecedented proportions. Against this backdrop, it becomes possible to grasp just how crippled a state the private sector is in and how encompassing those measures aimed at curing it must be.

It should not be forgotten that the policy pursued over the previous decade included contradictions out of step with the logic of a system revolving around the enterprise. The unfavourable cycle thus struck against structures undermined by medium-range phenomena.

During the last four months of 1971, the cyclical trend seemed to be improving: the recovery of industrial production fostered an increase in productivity and both these factors brought some relief to the economic situation of the enterprises. Imports began to pick up and exports continued to grow at a handy pace; investment moved upward again and consumption rose.

Statistical data for the beginning of 1972 do not, however, bear out earlier optimism. The revival in industrial production has sputtered to a halt, employment of non-agricultural dependent labour has fallen slightly, hours paid for by the Wage Equalisation Fund have increased. The large surplus posted for the exportation of goods and services points to the weakness of domestic demand.

The economic system is passing through a phase of cautious waiting. At present, no single component of private demand has shown any notable acceleration. The still unbalanced economic structure of the enterprises and the high degree of idle productive capacity do not help to brighten the investment front. Even consumption does not seem to bring about any marked additional stimuli. Public and state-controlled enterprise investment is still increasing but will not be able to keep up the exceptional pace registered in the last two years. Housing investment is suffering from the paradoxical situation that lets financial allocations lie idle because legislative and administrative provisions do not coincide.

There remain the possibilities of public intervention, which the annual plan for 1972 has gone into with great detail. This document contains an exhaustive argument on why the strategic variable of an economic policy designed for a situation of slack demand, but at the same time consistent with long-run targets, must not be indiscriminate public expenditure but investment expenditure. Within the framework of a rational evaluation of our economy's actual situation and of the interrelationships among the various aggregates which form it, the plan's authors quantify the amount of public investment necessary in order to bring the real income growth rate back up to that of the medium-term trend at 1,500 billion.

On the basis of factors which have become available since the plan was drawn up, the above-mentioned volume of investment is no longer feasible, owing also to difficulties that have cropped up in the process of decentralising some public works functions from the central government to the regions. For similar reasons, the achievement of the plan's hypothesis of a 5 per cent decrease in real terms in housing, assumed on the basis of increased public intervention in the sector, must be considered out of reach. In contrast, the recent decision to tack onto the provision for postponing VAT a measure making purchases of capital goods and inventories exempt from turnover tax is a positive element. This measure, eliminating the motives for putting off investment already decided upon, should have an immediate effect on what is at present the economy's weakest demand component.

We are managing an economy in which there are latent situations of financial stress and, even should recovery prove to be vigorous, it will still be necessary to embark upon bold action in support of enterprises in difficulty. Entire sectors will have to be subjected to rescrutiny of production policies pursued in the past, with the object of adapting their structures to the requirements imposed by acceleration of European integration. Government aid will be needed, especially when the rate of industrial plant obsolescence in the more traditional development areas is hastened by the setting up of plants with the aid of fiscal concessions and credit subsidies. If, however, on the occasion of the approaching negotiations for renewal of labour contracts, the agreements reached generate further increases in unit costs, then the expansionary credit and public expenditure policies, to which the authorities are unanimously committed, will be of no avail. Present indications suggest that the contracting parties might display a responsible attitude, in their awareness of the need to reconcile specific goals with general objectives.

Phenomena similar to those experienced in Italy have occurred in other industrialised countries, but this has not hindered the promotion of recovery through the adoption of appropriate policies: however, it should be kept in mind that those policies have given rise to concern regarding their repercussions on price stability, even though the disequilibria to be corrected are less serious than those facing Italy. In most cases, impetus is provided by public expenditure, by exports and, in some cases, by private consumption. In Japan increased production is being generated by these forces, but the pace is faster than elsewhere. Uncertainties are emerging as to the trend of long-term interest rates. Only in the United States has productive investment been harnessed resolutely to the growth process: imports are rising faster than exports and this situation constitutes the counterpart to the opposite trend in the rest of the world. In a certain number of industrialised countries, the formation of saving continues at a high level: this would seem to express the disinclination of the public to increase consumption oriented by market forces; and it should encourage public authorities to expand urgently the volume of resources allocated to social consumption.

This is an underlying objective of the Economic Development Programme 1971-1975: it can be attained through the contributory action of men who not only understand the problems posed by the transformations under way, but who also display constant awareness of the unremitting commitment to inventiveness, to modernisation, to farsightedness, demanded of the executive class, whether in the public or the private sector, in face of the competitive pressures from abroad and of the domestic pressures exercised by organised labour. The process of adapting our society's social structures to those of the more advanced countries is not without its tensions, but their severity will be diminished if the zeal of new energies strengthens the country's confidence in its own future.

* * *

The involution afflicting the economy calls for urgent solution. There are those who, critical of the very foundations of our system and, observing the difficulties with which we are faced, deduce that their views are correct and hope for early radical change. There are others, like myself, who believe in the principles on which the present system is founded and who are aware of the need for adaptation of economic institutions to the requirements of the times; and who, believing that the principal causes of the imperfections of the system lie, human error apart, in delay in that adaptation, are engaged in providing the necessary remedies. My remarks, and the entire document presented to you today, are intended to be a cognitive instrument which, by providing ample information, in observance of scrupulous objectivity in presentation and in the search for logical connections, contributes to promotion of the necessary choices. The document has been compiled by the research department, with the assistance of all departments of the central administration and of the branches, which have for the first time been co-ordinated for the purpose on a regional basis.

Economic and monetary maladies are by no means new phenomena in the history of a large number of countries, but no remedy can succeed in being effective without the contribution of those who believe that the search for truth is never divorced from the interests of the nation. In 1762, Cesare Beccaria introduced his discussion of Milan's finances thus: "The malaise of the monetary system is of such importance for public and for private reasons that it is not surprising that it should be one of the more commonplace topics of discussion in those countries which have the bad fortune to experience it. Most men lack the strength to rise to great and universal principles and, through analysis, to unravel ill-considered ideas, the only means of revealing the true state of affairs: others play upon human weakness and, with the facile superiority of obscure terminology, create within society a comedy of errors permitted by the submissiveness of the many and by deception on the part of the few. And so there are repeated declamations, theories and aphorisms regarding money matters, most of which no better than silence". We believe that over the years we have, through our Reports, contributed to the discovery of the *true state of affairs*; if we have not succeeded in this, we have at least succeeded in our purpose of stimulating discussions, from which a better understanding of the problems which we are beset with has emerged.