Concluding Remarks for 1973

The Repercussions of the Oil Crisis on the International Monetary System

The Report on the financial year 1973 is being presented to the Annual Meeting of Shareholders at a time when the senior management of central banks is perforce showing its extreme concern over the development of inflationary phenomena of unprecedented proportions. The notes issued by their banks still bear traces of the traditional undertaking to guarantee their convertibility into coin. This undertaking was an expression of the belief that convertibility would have protected the notes' purchasing power from the exercise of discretionary powers vested in parliaments and governments. It was fulfilled throughout the years when those in power, on the national and international level, were observing rules of behaviour compatible with the system they had accepted and which they forced others to accept. In the summer of 1914 that system was shattered.

The contrast between the social classes has become sharper and cannot always be interpreted in the conventional terms of class struggle: within their ranks, the heightening conflicts arising from disparity of bargaining power have been exacerbated by the expansion of the public sector and by its division into autonomous component parts, which brook no limitations on their independence. The sum of the demands made by the social classes on the national product tends to exceed the dimensions of that product, inflation has become the means whereby the sum of demands is brought within those dimensions. Inflation "renders all aspirations for income distribution compatible with the real flow of resources. The more individuals or groups succeed in protecting themselves against inflation reducing their purchasing power, the smaller is the area over which the erosion of purchasing power will occur and, all other things being equal, the higher will be the rate of inflation".

The attainment of independence by nations formerly under colonial rule generates, among countries, income-redistribution effects not dissimilar to those existing within each nation as a consequence of conflict between individuals or groups. The relations according to which raw materials and manufactured goods are exchanged change, and higher proportions of the income of manufacturing countries must be transferred to the countries from which they obtain their supplies.

The very awareness that there should be limits on the despoilment of the natural environment leads to an immediate lowering of the economy's productivity. Greater difficulties in procuring raw materials and energy sources, and more respect for our natural environment, lead to cost increases in those sectors where, in the past, higher productivity compensated for waste in other sectors.

The inflationary process associated with the aforementioned structural factors has been interacting in two ways with the international monetary crisis. On the one hand, inflation has been heightened by the growth of, and has concurrently intensified the demand for, international liquidity. And, since satisfaction of that demand by raising the price of gold was denied, there being no alternative, it became necessary to meet it with additional creation of the only universally accepted currency: the dollar. It became impossible to comply with this requirement without altering the official price of gold: it was necessary to sever the link with the yellow metal in order to achieve compatibility between the supply of and the demand for dollars. The multiplier mechanisms operating through the Euro-dollar market were accentuating the endogenous character of international money creation.

On the other hand, the need to check the spread of the inflationary process was inducing some countries to introduce exchange-rate flexibility: recourse to this expedient increased when it became evident that inflation rates differed in the various countries. The greater divergence of inflation rates was inducing surplus countries to protect themselves from imported inflation by allowing their currency to appreciate, while the deficit countries were seeking to restore equilibrium to their balance of payments by allowing their currency to depreciate. The area of uncertainty was widening, speculative propensities became more pronounced, thereby heightening the uncertainty.

The worsening of inflationary pressures, which could not be controlled by recourse to monetary policies compatible with the existing social order, was eroding the credibility of those authorities which the general public holds responsible for protecting the purchasing power of money.

The debate over the principles which were to have guided the reform of the international monetary system had resulted in a wide consensus on several points: *a)* all countries, deficit or surplus, regardless of their economic weight, should be placed on the same footing as regards the acceptance of the constraint of balance-of-payments equilibrium; *b)* stimuli should be introduced into the system to hasten adjustment processes based on fixed but adjustable parties; *c)* measures should be taken to prevent the financing of balance-of-payments disequilibria by expanding international liquidity through increases in the volume of reserve currencies; *d)* the volume of liquidity should be adapted to the growth of trade by creating an abstract currency under the control of the international community; *e)* gold should cease to be the unit of account for calculating values and should simply be considered as a commodity, thereby enabling transfers between central banks on the basis of market-related prices.

After the announcement of the oil price increases, the international institutions warned that the world was moving towards a new situation, marked by huge balance-of-payments surpluses and deficits, respectively, of the exporting countries and the importing countries. These institutions urged the importing countries not to seek restoration of current account equilibrium in the short run, which would result in competitive devaluations and quantitative trade restrictions. In the final analysis, the international monetary system would have to adapt to the need to accommodate considerable balance-of-payments disequilibria for several years to come.

Pending an agreement by the monetary authorities, disequilibria have been financed by resorting to the Euro-dollar and Euro-currency markets. When the balance-of-payments deficits are financed by withdrawing dollars deposited in the United States to transfer them to the oil-exporting countries, which thereupon deposit them with Euro-market banks, then the lending capacity of that market is increased. If the central banks of the importing countries borrow back these funds from the Euro-market, gross global reserves expressed in dollars are doubled.

The sequence of capital movements outlined above might lead to the conclusion that the Euro-dollar market is capable of financing deficits of unlimited dimensions. It would seem to offer a larger margin of elasticity than that obtainable if the funds transferred by importers were deposited, wholly or partly, by exporters on the individual national markets. The latter are subject to central banks' control, while the Euro-dollar market is not. But it would be quite wrong to deduce that there are no limits to the Euro-dollar market: in point of fact, beyond certain quantitative limits, the holders of funds might prefer to switch them to the US market and possibly invest them in equities, thereby creating liquidity problems for the system. But above all, over a period of time individual borrowers could find themselves up against limits imposed by the market's assessment of their creditworthiness.

If the disequilibria to be financed remain as large as those estimated for 1974, and if the oil-importers' deficits are financed wholly through the Euro-market mechanism, in the space of three years the volume of Euro-deposits could reach that of the means of payment existing in the United States. A limited number of banks, not subject to controls, would be in the position of managing this volume of funds, whereas within the United States they are spread among several thousand banks operating in a highly competitive market, controlled by an authoritative system such as the Federal Reserve. To continue financing oil deficits through this mechanism would imply assigning international financial centres powers over the future of the economic policies of consumer countries. This would aggravate the situation towards which the weakest are heading and force them eventually to reduce their share of international trade through restrictions.

Warnings have been issued by a number of sources on the dangers of a situation in which the dollar becomes, at one and the same time, the currency most in demand and the currency most freely available: the greater the volume of dollars held by oil-exporting countries, the greater the possibility of sudden conversions into other currencies. Huge waves of capital would again start flowing, at times into the dollar, at times out of the dollar, into currencies or goods offering a better purchasing-power assurance. The strengthening of the dollar is no protection against the violence of erratic capital movements: it would be difficult to substitute other currencies for the dollar as a universal instrument for international settlements, but at times of general uncertainty they represent an alternative hedge.

As the volume of liquid funds increases, they become more mobile. They are switched from one bank to another, from one market to another, from one currency to another, thus heightening the danger of liquidity crises and magnifying exchange-rate fluctuations.

In consideration of these dangers, we have obliged Italian banks to balance the maturities of lending and borrowing operations in foreign currency and to balance their overall foreign exchange position. The latter is no longer calculated on a global basis, but separately for the following currencies or groups of currencies: the United States dollar, currencies of the member countries of the European Economic Community, other foreign exchange account currencies. In addition, we have subjected the activity of money brokers operating in Italy to various controls, including the requirement that they notify the UIC (Italian foreign exchange office) of operations concluded each month among residents and between residents and non-residents. It has been determined from these reports that the volume of such intermediary activity is about 10 billion dollars a month.

Therefore, it seems imperative that the countries concerned become less dependent on international free markets and programme deficit financing in such a manner as to restrict the international dollar liquidity multiplier process. But this policy requires that bilateral solutions give way to multilateral solutions.

The rise in the price of oil marks a breakdown of the erstwhile accepted model of distribution of the world product. The demand for a larger share is expressed in behaviour of an oligopolistic, or almost monopolistic, nature, just as within individual countries it is based on the oligopolistic organisation of the markets for the factors of production and for goods.

The rise has created a general problem: it affects all countries, but a number are affected particularly seriously, such as those that depend more on oil imports. This distribution of the economic impact of the price increase stresses the different positions of the various countries as a result of their diverse ability to finance deficits. The difficulties are spreading from the weakest to the strongest, until they attack the entire international community. In point of fact, the change in the distribution of the world product caused by the traumatic increase in the cost of oil is exacerbating the instability of prices and exchange rates.

The financing of the oil deficit cannot be assigned to a sole mechanism for the creation of international means of payment since, at present, no mechanism would alone be capable of performing such complex functions. The situation calls for a joint search for solutions in which consumer and producer countries participate with a view to providing the system with new financing possibilities.

The creation by the International Monetary Fund of sufficient amounts of SDRs would allow the burden of financing disequilibria to be distributed among international settlement instruments other than the dollar: but it would encounter hostility. A special credit facility would not result in an increase of international liquidity in dollars, on condition that the financing of that facility were provided by oil-exporting countries. The latter appear to be inclined to make only a modest contribution.

The complexity of these problems demands that gold be restored to its function as a means of settling payments imbalances. Last year, we suggested that as an alternative solution to raising the official price of gold "the notion of an official price could be done away with altogether. In this case, the central banks could exchange gold among themselves on the basis of an agreed price and sell and purchase the metal on the free market".

In April 1974 the finance ministers and central bank governors of the EEC countries studied the possibility of central banks exchanging gold at a market-related price: the agreements between central banks would be freely reached and none of them would be obliged to buy or sell. Opinions differed as regards granting the power to purchase gold from the market, since exercising that power could, in the medium-term, result in an increase in the overall quantity of gold held by the central banks. It was objected that the power to operate in one direction only could, in the absence of agreements between central banks, cause wider price fluctuations. This objection was countered by the suggestion that a solution could be obtained through the creation of a "buffer stock", to which central banks could sell gold, receiving in payment currencies advanced by other banks. The gold buffer stock would be gradually sold on the market and the currency so obtained would be restored to the lending banks. Management of the stock would be assigned to an international institution. If the International Monetary Fund were assigned that function, it would become the repository of gold that had been sold or deposited as a guarantee by the central banks; in exchange, the Fund would issue SDRs and gradually place the gold on the market.

The ministers and governors were of the view that the agreements reached should be implemented in the framework of co-operation with the United States and with the other countries concerned. The seriousness of the present problems is such that all countries, and Italy in particular, should seek solutions by strengthening that co-operation.

The solutions outlined above would make it possible to mobilise the gold at present frozen in central bank reserves. It should, however, be recognised that, even if the proposals were implemented, the disequilibria arising from the present price of oil would continue to generate disruptive effects on the system. Experience has proved that the description of the current crisis as "unmanageable" was well founded: this is borne out by the proposition that first the major oil-importing countries, and then those countries together with the exporting countries, would have collectively to seek solutions to prevent the multilateral system of international trade from disintegrating. At the Washington conference called by the United States in February 1974, the delegations, with the exception of the West German and Italian finance ministers, failed to agree on collective commitments which would have benefitted one and all.

Our interest converges with that of the major importers and, we believe, with that of the exporters, in seeking agreement on global solutions. A necessary condition for the continuous functioning of world trade is the agreed establishment of price relationships between oil and industrial goods that enable, in the medium term, the elimination of balance-of-payments disequilibria and, in the short term, their proper financing.

Immediately following the announcement of the measures for introducing the compulsory deposit on Italian imports, the US Department of State declared that the situation in which Italy had found it necessary to take such a step underlined the urgent need to reach effective international agreement in order to resolve rationally the serious problems created by the energy crisis.

Present behaviour is contradictory and is becoming increasingly incompatible with the maintenance of a trade system based on the principles underlying the major international institutions: IMF, GATT and EEC. It is accepted that countries with a balance-of-payments deficit due to the increase in oil prices should refrain from attempting short-term restoration of equilibrium. At the same time, the creation of an appropriate amount of SDRs to finance the deficits is rejected; there is opposition to the attempt to make an adequate amount of special credit available with the help of oil-exporting countries; any solution designed to restore mobility to gold in the international payments system is postponed, if not indeed rejected outright. Financing of the disequilibria is entrusted to the Euro-dollar market, in the knowledge that it will register abnormal growth and that further elements of uncertainty will be introduced into the international monetary system, thereby increasing the speculative movement of funds. Deficit countries are exhorted to re-establish global equilibrium rapidly: and yet, as soon as any of them take steps towards that objective, mercantilistic forces come strongly to the fore.

Financing of the Balance-of-payments Deficit and Credit Policy in 1973

In June 1972, we strongly recommended that gold should be excluded from the settlement of credit and debit positions which arose from foreign exchange market interventions to maintain the respective exchange rates of EEC currencies within the narrow fluctuation margins. Our view was based on the conviction that mounting inflation would force up the price of gold on the free market and that, sooner or later, the question would arise of removing the ban on central bank gold sales to the market, as well as of formulating criteria for fixing a price for transfers between central banks. The solution arrived at then was to allow Italy to carry out interventions in dollars: our gold reserves thus remained intact, despite the considerable balance-of-payments deficits.

In the light of experience, the intra-Community agreements were modified: settlements could be made in gold, but the price would not be fixed until a decision was reached on the role of gold in the context of monetary reform. In the outcome, settlement in gold was abandoned. Subsequently, the possibility of using Community currencies or dollars was extend to interventions within the Community margins.

Despite these expedients, the system was unable to withstand the strains originating from the divergence of economic and monetary policies. The proposal advanced by the Italian authorities during the early stages of joint floating, i.e. that it should be replaced by concerted floating (where EEC currencies would float together against non-EEC currencies without the central banks having to notify the market of their intervention limits), is beginning to find favour.

Between June 1972 and February 1973, when the Italian authorities intervened to keep the exchange rate of the lira within the EEC margins, gross interventions on the foreign exchange market totalled 4,860 million dollars. Between February and December 1973, they amounted to 2,710 million dollars, giving a total of 7,570 million dollars. In the first three months of 1974, interventions amounted to 3,160 million dollars, as a result of the huge oil and non-oil balance-of-payments deficit. Thus, between June 1972 and March 1974, gross interventions totalled 10,730 million dollars; net of swap operations with Italian banks this figure drops to 8,850 million dollars.

Despite interventions of this size, the actual rate of the lira on a trade-weighted basis has depreciated by 16-17 per cent since February 1973. Since it was allowed to float, the lira-dollar exchange rate has fluctuated between a minimum of 561.90 and a maximum of 672.50 Had we taken part in the joint float we would have been obliged to defend exchange rates varying between a minimum of 459.55 and a maximum of 576.30. We feel bound to observe that the markets would certainly not have believed in our ability to defend rates at these levels and that the loss of reserves necessary to do so would have been considerably greater than the loss we have in fact incurred. The fluctuation of the lira-dollar exchange rate was narrower than that of the Mark and the currencies tied to the Mark. This means that the instability of the lira rate against non-Community currencies would have been more pronounced than it actually was.

The foreign exchange necessary to cover net interventions totalling 8,850 million dollars was obtained by borrowing on the Euro-dollar market and by activating EEC short-term support facilities. Since this support consists of loans to the Bank of Italy, the net foreign position of the Bank and of the UIC (Italian foreign exchange office) dropped by 2,160 million dollars. In this connection it should be recalled that the central banks of all the Community countries, including those with balance-of-payments difficulties, participated in this support action. This show of solidarity is evidence of the desire to uphold the integration process. A study of the Commission's proposal to consolidate the short-term support system will be completed by September.

In April 1974, a Mediobanca 1,200 million dollar loan was concluded on the Euro-dollar market, thus bringing total compensatory loans over the last two years to 10,500 million dollars. Maturities mainly fall in 1975 and in the period 1979-1983: interest payments up to 1978 amount to approximately 700 million dollars per annum.

If an agreement on central bank gold transfers at a free-market related price is reached, Italy's solvency would be guaranteed by our net reserves, which at April 30 amounted to 16.7 billion dollars on the basis of the average market price for gold during that month.

Those who manage our economy are responsible for having imposed an unprecedented financial burden on the economy, and it is their duty to create the conditions which will allow that burden to be borne.

In recent times, there has been a widespread belief in Italy that our need to borrow is matched by the willingness of others to lend. On several occasions, I have attempted to dispel that notion. In July 1973, I stated that: "The absence of policies to protect our ability to meet commitments would completely destroy our credibility, with repercussions on both the domestic and international level. The Bank of Italy is directly involved in safeguarding that credibility: we could not remain indifferent to a serious erosion of the nation's credibility. Furthermore, the EEC Monetary Committee's report on Italy which was drawn up when short-term monetary support was granted, commits us to implement a stricter financial and monetary policy".

At the beginning of 1974, it was even more forcefully argued that we could continue to borrow abroad with ease: and it became increasingly difficult to combat the inclination to seek comfort in that impression. While inflation soared at an alarming rate, there was much argument about the supposed menace of deflation: understandably, the general public was becoming increasingly bewildered. There was even a succession of statements to the effect that international financiers wished to grant loans to Italy, whereas there were clear signs that the attitude was a very different one. The

Minister of the Treasury gave frequent warnings of the dangers inherent in exhausting our ability to raise loans abroad.

In a document drawn up in January, I stated: "Recourse to the Euro-dollar market is encountering difficulties which arise from the fact that many countries, including some non-deficit countries, are turning to that market: it is also faced with the difficulty that Italy lacks an economic and monetary policy which could prove her ability to solve the current serious problems in a manner compatible with continued membership in the Western community. It therefore follows that, without a reduction in the forecast global current account deficit for 1974, there is little likelihood of financing that portion of the deficit which should be financed abroad. The very international organisations which are exhorting member countries not to introduce quantitative restrictions make a distinction between the oil-induced part of balance-of-payments deficits and the part due to other causes. The situation therefore calls for measures that influence the level of domestic consumption of certain items, by recourse both to rationing and to price increases. But these measures would be ineffective unless linked to policies designed to restrict monetary demand, backed by action to contain the banking system's liquidity and the availability of short-term credit less tied to productive investment".

We reported that the Mediobanca loan was part of a programme which rules out further large-scale borrowing on the Euro-dollar market, unless the country has first embarked upon a credible policy for containing unproductive expenditure and thereby shown a willingness to adapt its standard of living to the new terms of trade. In the discussion with the trade unions, there was probably a lack of unanimity in stressing the limits within which social uses of national income would have to be contained. For a certain period of time, productivity increases would have had to be distributed not in the form of wage and salary increases, but used to limit the balance-of-payments deficit. It is inconceivable that we should go on asking for, and others go on providing, the credit necessary to finance a deficit which in absolute terms is nearly as large as – and in terms of income is much larger than – that of the United States when the dollar crisis was at its worst.

Increasing difficulties in gaining access to the international market made it necessary to find different sources for credit. It was in this context that it was decided to approach the International Monetary Fund: notice of this decision was given in a document drafted by the Budget Ministry for the February 6 meeting between the secretaries of the main political parties and the finance ministers, presided over by the Prime Minister. That document stated: "The search for funds to finance that part of the deficit caused by the oil crisis should be conducted along the following lines: *a)* recourse to the International Monetary Fund; *b)* utilisation of central bank swap facilities; *c)* recourse to the Eurodollar market". The document continued: "We can resort to the IMF's normal credit facilities and to the special facilities currently being finalised. Recourse to the former depends on the extent to which we adopt measures designed to limit considerably the part of the deficit not caused by the oil crisis".

The terms of the credit lines were defined around mid-February: agreement was reached on more liberal lines than those accorded in similar circumstances to the United Kingdom and to France. The letter of intent to the IMF allowed the Italian government wide scope for manoeuvre. The government undertook to pursue suitable policies to reduce substantially, during 1974, and eliminate by 1975, that part of the balance-of-payments deficit not ascribable to the oil price increases; it was left entirely to the Government to decide how to finance the oil-induced portion of the deficit, and how and when it should be eliminated.

Asked to comment on the commitments contained in the letter of intent, on March 5, I observed: "Continued recourse to the financing sources to which we have access is being taken for granted: I, personally, am of the opposite opinion. Many circumstances have combined to diminish our credibility on the international scene: if we wish to restore this credibility we must adopt a coherent economic policy to convince the outside world that we accept the balance-of-payments constraint, in the awareness that only if we do so can we continue to be members of the Western community".

"I am firmly convinced that, in the present conditions, there is no room for policies aimed at further increases in the gross national product, but only for policies aimed at improving its distribution. Of late, there has been too much discussion about growth models: we forget that any growth process can be halted by the lack of funds for meeting international commitments. Politicians must come to realise that valid arguments concerning domestic issues are not necessarily valid at the international level: the overriding objective must be to convince others, at home and abroad, that the government's economic policy is intended to place limits on the balance-of-payments deficit so that it can be financed now and in the future".

"No new expenditure is required to obtain the compensatory effects hoped for by those who worry about the inadequate expansion of global demand: any increases in revenue should be used to reduce the deficit. I am convinced that public-sector deficit financing will become increasingly difficult while there is widespread flight from money: it would seem superfluous to recall that financing can only take place with credit instruments denominated in money".

"I feel bound to express some concern over the possibility of achieving a 22,400 billion lire expansion of credit. Such a large increase is only possible if the public is prepared to acquire 19,100 billion lire's worth of securities, deposits and cash. But no coercion of any sort could induce the public to do so: only the reasoned conviction that government policy aims to limit the fall in the purchasing power of money could persuade most Italians to invest any increase in their wealth in monetary assets on the scale envisaged".

My observations at that time were in complete contrast to the belief of those who held that the deflationary effect of the balance-of-payments deficit arising from the deterioration of the terms of trade should be offset by increasing, in like amount, public expenditure financed by borrowing. True, the net reduction of the public's financial wealth resulting from a balance-of-payments deficit on current account could be offset by public sector expenditure-deficit financing: but, as I maintained, such expenditure, besides directly stimulating domestic demand, re-creates the public's net financial wealth and consequently also exerts an expansionary effect in this way. The overall growth of demand can create an even larger balance-of-payments deficit on current account than before. Borrowing abroad does not break this sequence of actions and reactions, but only allows the desired exchange rate to be defended: hence the need to maintain a suitable combination of domestic demand and public expenditure, so that the growth of the former due to the expansion of the latter does not set off a series of negative effects on the balance of payments.

Viewed in retrospect, the credit policy pursued in 1973 seems to have been expansionary, even though the goal was to contain the growth of monetary aggregates. The credit policy adopted made it possible to finance the recovery of investment which was accompanied by higher levels of employment, productive capacity utilisation and productivity. These results were reflected in an increase, in real terms, of gross national income of nearly 6 per cent, which is higher than the long-term trend and the highest rate attained by the Italian economy since 1968-1969. Considerable impetus was provided by investment demand: the increase, adjusted for the inflation component, was only exceeded in 1953, 1955 and 1960. Investment in machinery and equipment recorded the highest growth rate since 1950. Global demand was also boosted by an increase in stockpiling, which was accentuated by mounting inflationary expectations. The contribution of exports was lower than in the past, despite the expansionary trend of international trade, with the result that Italy's share of expanding international trade fell.

Towards the end of the year, the economy was beginning to yield to cumulative strains, aggravated by the oil-crisis. Quantitative restrictions on oil supplies and the escalation of international prices led to further speculative stockpiling. Domestic inflation was being fuelled by increases arising from the gradual freeing of previously frozen prices: this decision was the only alternative to avoid supply bottlenecks at a time when the enterprises' profit and loss accounts were increasingly affected by higher costs. Towards the end of the year, apprehensions about the future grew, mainly because inflation mounted while the balance-of-payments deficit continued to deteriorate. The growth rate of income slackened; industrial production came to a halt at the third-quarter level; prospects of further improvement in employment levels, founded on the earlier favourable trend of production, receeded. At the beginning of 1974, the rate of inflation was still rising and the balance-of-payments position was worsening. Some improvement in production and employment data foreshadowed the closing of an expansionary phase.

Throughout 1973, the authorities were faced, and still are faced this year, with the huge problem of how to finance the Treasury deficit, while keeping the resulting money creation in line with economic policy objectives. In 1973, financing of the Treasury generated monetary base creation of 7,230 billion lire; transactions with foreign countries accounted for 170 billion, rising to 2,370 billion if compensatory loans, largely frozen at the Bank of Italy, are excluded. In 1973, Bank of Italy and UIC financing to the banks (taking into account random movements at end-1972) amounted to only 280 billion, against 930 billion in 1972. The net effect in 1973 of these operations, including minor items, was an increase in the monetary base of 5,080 billion, as against 3,600 billion in 1972.

In the first half of 1973, the monetary base increased by 1,320 billion, that is, less than in the corresponding period of 1972 – despite the public's heavy demand for cash due to rising prices and to the wage and salary increases in the early part of the year. Consequently, the flow of liquidity to the banking system dropped considerably. In the second half of the year, control of monetary base creation was hindered by the huge growth of Treasury requirements: however, the effects on the expansion of credit were cushioned by the measures taken in June and July which placed quantitative limits on the granting of bank credit. Overall, the monetary base increased by 3,760 billion during the second half-year; the public absorbed 2,210 billion of this, while the remaining 1,550 billion flowed to the banking system, thereby increasing its liquidity considerably more than in the preceding half-year.

During the first six months of 1973, the balance-of-payments deficit generated a faster growth in bank lending than deposits. Credit rose by 2,700 billion lire, compared with a 760 billion increase in the corresponding period of 1972; deposits rose by 3,860 billion, against 2,240 billion in 1972. At the same time, the banks' portfolio holdings of negotiable bonds decreased by approximately 280 billion, while in the corresponding period of 1972 they had increased by 880 billion. This situation was accompanied by a lower propensity of the public to invest in bonds: in the first six months of 1973, private investors purchased 1,200 billion lire of bonds, while the corresponding figure for the preceding year was 1,510 billion. The combined effect of the circumstances had negative repercussions on the industrial credit institutions' ability to mobilise funds to the point of raising doubts about their ability to continue disbursing funds. Simultaneously, the expansion of bank credit appeared to be influenced even more by the financing of speculative transactions.

Under these circumstances, it was decided to introduce a measure requiring the banking system to invest in bonds an amount equal to 6 per cent of deposits at end-1972. There were two aims behind this measure: to channel a larger share of financial savings into productive investment, through the intermediation of industrial credit institutions; and, at the same time, to protect the bond market against the possible effects of the restrictive credit policy. Since the expansion capacity of overall credit is linked to monetary base creation, to respect the obligation to invest in securities would have necessarily resulted in a reduction of the banks' ability to grant ordinary credit. In order to counter possible distortions, to the detriment of productive activity and of smaller-sized enterprises, it was decided to curtail the growth of overall loans to those sectors where speculative phenomena were more pronounced along with that of larger-sized loans.

In practice, the introduction of compulsory investment in bonds, together with limits on loans to the various categories of borrowers, reconciled two major requirements: avoiding a sudden drying up of the flow of credit to enterprises, especially the smaller-sized ones, at a time when productive investment was picking up considerably; and gradually bringing credit expansion back within the limits imposed by the urgent need to combat the heightening of inflationary pressures and the deterioration of the balance-of-payments deficit. These considerations motivated the July proposal (implemented in September) to raise the official discount rates, in order to restore them their function as regulators of the banks' demand for central bank refinancing. The official rates were raised to 6.5 per cent, while the penalty rates remained unaltered. In addition, it was decided to issue ordinary Treasury bonds bearing a deferred interest rate of 9.64 per cent per annum, in line with the rate then prevailing on the money market: the maturity of these bonds was fixed at six months.

The margin of autonomy granted to the banks allowed them to increase their lending by 20 per cent in 1973, compared with 18 per cent in 1972 and 13 per cent in 1971. Financing by the special credit institutions recorded an increase of 26 per cent.

Taking enterprises and the housing sector together, financing obtained from the credit system, plus finance directly acquired by placing securities and taking out loans abroad, totals 14,650 billion lire, equivalent to 18 per cent of gross national income at 1973 current prices. Including funds transferred by the public administration and self-financing, this volume of credit made it possible to finance investment amounting to approximately 15,500 billion lire and increased the enterprises' financial assets by about 7,000 billion. If the enterprises' financial assets are added to those of the households, the total comes to 21,710 billion, against 17,400 billion in 1972. There was a shift in the composition of these assets in favour of liquid assets, which rose by 23 per cent, against the 10 per cent increase of non-liquid assets. This phenomenon is typical of periods of inflation.

The switch into real assets was curbed by the increase in bank interest rates, followed by the raising of rates on Bank of Italy advances and discount operations to 9 per cent at end-March 1974, with the penalty rates unchanged at 3 per cent.

Compulsory investment in securities was subsequently extended by a further 3 per cent and until the first half of 1974: the Bank of Italy was empowered to establish the qualitative composition of the securities which the banks may purchase. If securities issued by the special credit institutions for financing investment were substituted with securities issued by the same institutions on behalf of the Treasury, it would be easier to finance Treasury requirements without causing an exhorbitant monetary base creation.

In April this year, the regulations relating to bank credit were renewed: between end-March 1974 and end-March 1975, there will be a 15 per cent ceiling on the growth of lending by every bank, with the exception of financing provided for electricity enterprises, the state railways, AIMA, health authorities and businesses with indebtedness below 30 million lire. Within the overall limit, a 12 per cent credit-expansion ceiling has been placed on each bank for loans to financial and commercial enterprises and private customers, 15 per cent for loans to local authorities and 15 per cent again for the remaining customers with loans outstanding over 500 million lire. No limit was placed on customers with indebtedness between 30 and 500 million lire, provided that the total amount of credit provided to this category is within the overall limit of 15 per cent.

The introduction of the ceiling, and limiting it to 8 per cent up to September 30, make it possible to carry out a thorough control on the expansion of bank lending, in line with the commitments undertaken with the International Monetary Fund. Should it become impossible to provide for public institution financing on the securities market, thereby forcing the Treasury to increase its recourse to the Bank of Italy, it will be increasingly unlikely that regulation of the monetary base could succeed in keeping credit expansion within the limits created by existing monetary policy objectives. This eventuality could lead to direct controls on the volume and utilisation of credit, resulting in a curtailment of the decisional power of bank executives and the consequent bureaucratic degeneration of the banking system.

Furthermore, bearing in mind the delay in appointment, or reappointment, of senior bank executives – because of the politicians' inability to reach an agreement and the growing politicisation of such appointments – it is hardly surprising that our banking system finds it difficult to show the strength of imagination which many expect of it. The freedom of senior bank executives is further threatened by the bank workers' unions' insistence that they should participate in credit-granting decisions. To yield to these demands would conflict with the fulfillment of public interest objectives upheld by politicians and trade unions at the national level.

Policies for containing credit expansion force the monetary authorities to find a way of preventing the adjustment between credit supply and demand from having a greater impact on certain sectors of production and on the smaller enterprises. Experience shows that, in periods of tension, credit is increasingly granted to the larger enterprises. The measures taken in July 1973 and April 1974 were dictated by the need to protect the smaller enterprises, considering the link between total loans and the size of the beneficiary enterprises. Final figures indicate that the effect was to protect small loans: during the year these continued to grow at the same rate as in the second quarter, the fastest recorded in the past five years. Loans of 500 million lire and over, which had been growing fastest during the preceding five years, slackened considerably, so that their increase between March and December was the lowest recorded for five years. In the second half of 1973 there was a marked drop in the volume of loans calculated on the basis of the size of overall indebtedness. Selective controls on the distribution of credit by sector of economic activity seem to have been less effective.

Finally, the July 1973 measures have been successful in ensuring a wide availability of credit for small enterprises during a phase of tendential restriction. There have been no signs of the rationing of smaller loans observed in 1969 and 1970: indeed, the concentration has fallen below its normal values. The banks have granted more loans with a higher than average risk factor and this has helped to push the average lending rate higher.

It was in the light of the positive results achieved that the April 1974 measures were introduced. They were based on the conviction that large enterprises have access to alternative sources of financing. They are not only able to attract a larger share of special credit, but can also obtain credit from smaller-sized enterprises by adjusting the terms of payment in their dealings with the latter.

Concerted action of the Treasury and the Bank of Italy has conformed with the objective of broadening the range of instruments available on the financial and money market, with a view to attracting savings, which would have been invested elsewhere, to the market for intermediation. One form of intervention was to facilitate investment in shares, despite the fact that in Italy during the 1960s they did not offer the investor sufficient protection against the reduced purchasing power of money. Another form of intervention is to issue shorter-term securities, or securities backed by clauses to limit the size of price fluctuations by periodic adjustment of yields. We have increased Treasury financing by recourse to three-month ordinary bonds and when long-term bonds were renewed we offered four-year bonds. We have carefully pursued a policy of intervention on the quotations of long-term bonds and other securities issued on behalf of the Treasury.

The Balance-of-payments Adjustment Process and Credit Policy in 1974

The transfer of purchasing power to the oil-exporting countries following the price increase represents a drain on Italian resources estimated at around 3 per cent of GNP. One can attempt a different approach by taking into account the income multiplier variations arising from changes in marginal propensity to import: assuming that the oil price increase is transferred wholly to the domestic market, the effect would be a reduction of approximately 5 per cent of national income in 1974. This latter method which measures the deflationary effect of the oil price increase is adopted in support of a need for compensatory measures designed to prevent a contraction of income. This point of view assumes that the transfer of income to oil-exporting countries is not matched, wholly or partially, by a reflux in the form of an increase in their imports from, or productive investment in, the industrialised countries: it also implies that it would be possible to obtain foreign loans in sufficient amount to finance the balance-of-payments deficit resulting from the absence of a reflux.

The government's action in formulating investment programmes to counter the country's diminished purchasing power caused by the higher cost of oil products conforms with the recommendations of international institutions, which have expressed concern over the deflationary effects of policies aimed at immediate restoration of balance-of-payments equilibrium.

We have already stated, and wish to repeat now, that such a policy is not appropriate for Italy's economic conditions. In Italy's case, the wage increases stemming from the national labour contracts and collective bargaining and the spreading of price increases through the escalator clauses exert much of the compensatory effect that the investment programmes would be expected to perform. The increase in public expenditure attributable to transfers continues to act in the same direction.

During 1973, imports rose by 13 per cent in volume and by 44 per cent in value; exports increased by 4 per cent in volume and 20 per cent in value. The larger increase in import values as opposed to export values may have stemmed partly from over-invoicing of the former and under-invoicing of the latter. During the first half of the year, random factors helped to expand imports and reduce exports: but even when their effects faded out, the divergence between the growth of imports and that of exports confirmed that domestic demand was rising faster than domestic supply. The ratio of import growth to GNP growth was higher than in the past, thus offering further evidence of the tensions to which the Italian economy was subject.

The tendency to pay for imports in advance and to defer collection of payments for exports helped to aggravate the balance-of-payments deficit. The administrative measures limiting the terms of payment along with the compulsory deposit of 50 per cent of amounts invested in foreign securities, heralded a return to the foreign exchange control policy from which the country had been freed in the years of economic reconstruction.

In the first quarter of 1974, more than half the trade deficit was attributable to factors other than the higher cost of oil products. Since there is nothing to indicate that the volume and composition of domestic demand and supply are automatically adjusted to the changed terms of trade, appropriate policies are necessary to curtail domestic demand by reducing public expenditure or by considerably increasing taxation, or by a combination of the two. Since we were convinced of this fact we insisted that the "substitutive investment" programmes be kept within much narrower limits than those based on the expected demand vacuum due to the higher cost of oil products. Instead, expenditure programmes were formulated to develop special projects costing thousands of billions of lire, and the trade unions urged their implementation.

The size of the balance-of-payments deficit, and its increase, provide confirmation that the financing of mounting public sector deficits with monetary instruments, together with the public and private sector wage and salary increases granted under pressure of sectorial claims, have not only compensated for the deflationary effect of higher prices for oil products but also have superimposed an autonomous inflationary effect. Subsequent events do not appear to confirm the fears of those who believed that the restrictive effects of oil price increases and their transfer onto domestic prices should not be aggravated by those of deliberate limitation of demand by the government. In the event, the fiscal measures intended to reduce consumption of certain goods with a high import content have not led to the expected containment of demand: some measures were not implemented, and those that were proved relatively ineffective. Furthermore, the wage and salary increases in the motor-vehicle industry have dealt a severe blow to the structure of money incomes.

The need to rid ourselves of excess domestic demand emphasizes the urgent need for an incomes policy: without it, credit restrictions and the consequent concentration of the adjustment process on investment are inevitable. In the conclusion of last year's Report, we stated that the trend of the balance of payments on current account indicated that a state of full utilisation of productive capacity was approaching, taking into account the limits placed on such utilisation. On that occasion we stated: "Conditions are looming that will make it necessary to use demand-regulating instruments in order to curb pressures on real resources: there will appear a clear-cut need for corrective intervention through increased taxation. If interventions to regulate demand are carried out through monetary policy measures, they are bound to run up against the tightening of constraints due to the expansion of the volume of long-term securities created for financing the public sector's needs".

To survive, our economy must move towards balance-of-payments equilibrium without making a distinction between oil deficit and non-oil deficit. We must programme the volume of external indebtedness within the limits of our ability to obtain credit from either public or private sources: these limits depend on how capable we show ourselves to be of restoring equilibrium to foreign accounts and of combatting the various inflationary pressures operating within our economy. Once our creditworthiness is eroded, we will be unable to avoid reducing imports, including imports of raw materials: there would thus be a more drastic fall in the level of economic activity than that deriving from timely financial and monetary policies to restrict domestic demand.

The oil crisis makes it necessary to adapt the structure of our economy immediately to the changed terms of trade between raw materials and manufactured goods. First, two conditions must be fulfilled: the mobility of the factors of production, so that they may be channelled towards the sectors more directly associated with exports; and a rate of inflation no higher than that existing in competitor countries. The hardening of labour relations together with the uncontrolled growth of money incomes have the opposite effect.

During the years in which our economy was expanding, productivity increases in certain directly productive sectors offset the wastage of resources in sectors where they were being used irrationally. Recently, however, the area of high productivity has been eroded by an increase in the inherent parasitism of public expenditure, in bureaucratic paralysis and in the civil service.

The adjustment which must be made in our economy in order to restore balance-of-payments equilibrium must force the government, local authorities and trade unions to accept that the priorities given to individual aims be redefined. A refusal to revise programmes in the light of the balance-of-payments situation will mean that it will take even longer to reform the system and that the process will be all the more severe and painful.

The government should concentrate upon stating the ultimate objectives and creating the general conditions for their achievement. Within that context, public and private enterprises should be free to respond to market pointers; managements should be judged according to the economic results achieved. If, instead, orders encroaching upon the area under the direct responsibility of business executives continue to be issued – as increasingly occurs – then the economy's loss of efficiency will become irreversible and, at the same time, ties with the international market will be severed. It would be necessary to be resolute in redistributing investment, with the accent on the directly productive sectors. The incentivation policy should be re-oriented to aid industries producing goods for export or goods to substitute imports. The efficiency of our economy depends on the ability to extend the area of consensus to a system based on the enterprises' autonomy.

In recent years, we have been witnessing an increasingly pronounced decentralisation process in which new industrial projects are set up beyond the major industrial concentration areas of central Europe. In this process Italy has been largely by-passed: few projects have been located in the regions where incentivation was intended to accelerate the industrialisation process. One should ask oneself whether or not this state of affairs depends on the fact that incentivation, and the way in which it has been managed, creates an environment little suited to offer the conditions in which a modernly run industrial enterprise is able to prosper. With the increasing attraction of locating new projects in countries that produce raw materials, it becomes all the more urgent to create the right conditions for autonomous entrepreneurial development in areas where we wish to stimulate industrialisation processes that strengthen our economic ties with the rest of Europe.

The unsatisfactory trend of exports throughout 1973 is attributable to two principal causes: the sharp growth of domestic demand and the consequent tendency in many productive sectors to give priority to the home market over the foreign market; and the inadequacy of supply due to the succession of strikes during the year, which increased the Italian industry's difficulties in meeting delivery dates. Besides cyclical factors, our export trade was adversely affected by other factors that reflect a longer-term trend: the secondary chemical and precision engineering industries, as well as the advanced technology sectors, are suffering from inadequate development in the area of scientific and technological research. Meanwhile, the textile, clothing and footwear industries are loosing ground to countries where economic development is more recent and which have an advantage over Italy as regards labour costs. The present outlook for exports is clouded by declining international demand and by higher cost and price increases than our competitors.

If we are to maintain our position on the international market, we must bring the relationship between wage increases and productivity growth into line with that existing in the industrialised countries with which we have to compete. Legislation and agreements have made wages more independent on productivity: reduction of working hours, bans on overtime and double shifts have improved the quality of life within the factory, but they have reduced the possibility of compensating wage increases by higher productivity. The problem at present is not one of the quality of life in the factory, but of keeping the factory alive.

Extending principles, such as guaranteeing wages in the event of a temporary halt in work, would lead to the closure not only of the individual enterprise, but of a whole series of enterprises, when our lack of competitivity renders it impossible to obtain supplies of raw materials. Wage equalisations through a more sensitive escalator mechanism introduce a further hurdle to the adjustment process in an economy subject to explosive inflationary pressures. The linking of pensions to wage increases further divorces earnings from production: if pension increases are financed by the enterprises' social security contributions, costs increase; if they are financed by the state, without recourse to higher taxation, the budget deficit worsens and inflationary pressures are intensified.

The legislation relating to social security (Presidential Decree No. 488, April 27, 1968; Law No. 153, April 30, 1969; Law No. 485, August 11, 1972; Law No. 114, April 16, 1974 and other measures) and the complaisance in granting disability pensions have resulted in increased transfers of income without there being accordingly a rise in taxation. Law No. 336 of May 24, 1970 and Law No. 824 of October 9, 1971 have promoted the early retirement of war veterans and similar categories employed by the state and public bodies; Presidential Decree No. 748 of June 30, 1972 has facilitated the voluntary early retirement of senior civil servants. And so the ranks of the nation's unemployed continue to swell.

Disparities between wages and salaries in the public and the private sectors, and within the various branches of each, are now greater than in other developed countries. The high earnings won by groups to which politicians are more inclined to yield encourage the lower paid groups to press for similar increases, thereby sparking off a damaging wage scramble, which is also fuelled by the mounting rancour of the unprotected groups.

Uncertainty regarding the framework within which one can operate, owing to innovatory legislation and the conflicting interpretations of existing legislation, is inhibiting any form of planning at all levels, which in the final analysis denies the rational utilisation of the nation's human resources.

A balance-of-payments adjustment process can be embarked upon when the behaviour of individuals and groups is consistent. If, in conditions of full or near-full employment, people demand more services from the government, the regional and local authorities and the autonomous government agencies while refusing to bear the cost by paying higher taxes, then they are asking the economy to provide more resources than it can offer. The shortfall in resources is met from abroad, by importing more goods and services than are exported. This behaviour can be likened to that of a country which, instead of taxing its own citizens, thinks it can tax the citizens of neighbouring countries. People who have some sense of responsibility cannot continue to conceal their incomes in Italy and abroad and, at the same time, expect the state to provide protection, education, public services and all the credit necessary to finance the enterprises from which they draw their incomes. It would be impossible to achieve the adjustment that our economy must undergo unless the ruling classes win consensus by their behaviour.

In 1963 and 1969 Italy experienced balance-of-payments crises; in both instances, the use of credit policy instruments made it possible to overcome the crises without resorting to restrictions on imports; there followed a slowdown in productive activity, but our economy's capacity for recovery did not suffer. During the interval between the two crises, the growth rate of income remained high, even though its distribution was unsatisfactory. The balance of payments on current account registered a surplus, which resulted only partly in an increase in foreign currency reserves. The price level was as stable as in those countries least willing to accept inflation. During those years, some countries revalued their currencies while others devalued; there were balance-of-payments crises, imports quotas, restrictions, the creation of compulsory deposits and additional tariffs on imports. But this succession of events did not stop trade from acquiring greater impetus within a system of interdependent economies.

One should ask oneself whether the same monetary policy instruments can be used today to achieve the same results. Two elements distinguish today's crisis from the preceding ones:

a) in 1963 the balance-of-payments deficit originated from the balance on current account and represented 1.4 per cent of national income; in 1969 its origins lay in capital outflows that were huge in relation to the current account surplus. This year the expected deficit, including the oil deficit, represents about 6 per cent of income: this ratio is without precedent in any industrialised country;

b) in 1969 the households' financial saving amounted to 6,300 billion lire and the portion of this flow used by the public administration and the autonomous government agencies stood at 1,850 billion, that is 29 per cent; in 1973 the households' saving was 13,250 billion lire, while the public sector used 8,260 billion, or 62 per cent.

In Italy, the ratio of the volume of financial assets to income has become greater than in most industrialised countries. Consequently, the effects of monetary policy are wider-reaching and the policy-makers have greater responsibilities. Since the public administration uses a larger percentage of savings in Italy than in other industrialised countries, defending the portion allocated to production involves a harder struggle during credit squeezes. Over the last five years, the increased services supplied by the public administration have not been matched by a rise in taxation: consequently, savings were tapped to a greater extent. Higher taxation would have been partially offset by reduced formation of savings; this, in turn, would have led to a smaller accumulation of financial assets in the form of bonds, deposits, bank-notes. There would be less danger of people converting their financial assets into cash, thus compromising the effectiveness of policies for curbing demand.

Years ago, the law and its statutes forbade the Bank of Italy to finance the public sector or placed rigid limits on the extent of that financing. Heroic behaviour was not required of the Governor of the Bank: he was only expected to be a diligent administrator, checking that the relative proportions between the various balance-sheet items, as set by the law, were observed. Heroic behaviour is not required of him today either, but he is expected to reconcile objectives belonging to a vaster framework: growth of income, full employment, price stability, balance-of-payments equilibrium. When these objectives can no longer be reconciled, choices must be made. On the occasion of the previous Meeting of Shareholders, we stated that: "Should it become necessary to limit the overall volume of credit, the reduction, owing to the rigidity of the public sector's demand, would mainly affect the directly productive sectors".

1928 saw the abolition, under the Issuing Institutes Act, of the ceilings on Bank of Italy investments in government or government guaranteed securities. We asked ourselves then, and continue to do so, whether the Bank of Italy could have refused, or could still refuse, to finance the public sector's deficit by abstaining from exercising the faculty, granted by law, to purchase government securities. Refusal would make it impossible for the government to pay the salaries of the armed forces, of the judiciary and of civil servants, and the pensions of most citizens. It would give the appearance of being a monetary policy act; in substance it would be a seditious act, which would be followed by a paralysis of the public administration. One must ensure that the public administration continues to function, even if the economy grinds to a halt. Moreover, the consequences of administrative chaos would be more serious. We cannot halt the drop in economic activity with only monetary policy instruments; we can use them to cushion that fall.

The banks and the special credit institutions are worrying about the pressure to which they are subjected by borrowers. The institutes and the bodies which raise funds by issuing bonds are faced with increasing difficulties and request permission to resort to new forms of fund-raising. Indexed issues covering all securities would tend to lower the prices of those in circulation; indexing is effective if limited to certain sectors of the financial market and if it remains optional for the parties involved. Industrial, real-estate and agricultural credit institutions and their central institutes are calling for help from the Bank of Italy. We have been, and will continue to be, deaf to their cries. In our economy, priority must be given to respecting the constraint of balance-of-payments equilibrium. The means for achieving this are well known; there are no miraculous cures: it is necessary to reduce the creation of funds destined to finance the public sector.

The links between Treasury deficit, balance-of-payments deficit and price level are not incomprehensible as we propose to show.

During the year from March 31, 1973 to March 31, 1974, the Treasury deficit led to monetary base creation of 7,780 billion lire. During the same period, the draining of monetary base owing to the balance of payments on current account can be estimated at around 2,500 billion; if one includes capital movements, the reduction caused by the balance of payments rises to about 3,500 billion. Bank of Italy operations pumped liquid assets for 990 billion into the system, mainly in the form of advances to the savings banks' central institute, as a result of the savings banks' withdrawals from their deposits with the Bank of Italy under the pressure of the demand for credit. The monetary base thus created, including the amount accounted for by

Post Office deposits, was overall 5,150 billion; 3,470 billion was used by the public, of which 1,600 billion in the form of currency in circulation. The difference found its way to the banks and, along with a reduction in excess reserves, made it possible to satisfy the compulsory reserve quota.

The monetary movements described are the practical result of the Treasury's requesting a larger quantity of resources from the economy than the latter proved capable of supplying. The difference was supplied from abroad. Assuming that the contribution of resources from abroad had not been sufficient, and given the Treasury's requirements and the method of financing them, the excess of demand over supply – which was financed by the increased credit resulting from monetary base creation – would have caused a far greater rise in prices than that which occurred. Foreign accounts would have been kept in equilibrium through an exchange-rate change. The excess of demand over supply would have been eliminated by a higher degree of inflation.

Had we wished to restore equilibrium to foreign accounts without undergoing greater inflation, the Treasury deficit would have had to be financed by increased securities issues placed with the public and/or the banking system to about halve recourse to the Bank of Italy. The volume of credit which flowed to the enterprises through the banking system would have been several thousand billion lower than it in fact was. In this case, the equilibrium between demand and supply would have been restored by tightening demand on the investment side.

Balance-of-payments equilibrium could have been achieved by increasing taxation on the households' available income. In this case, the restriction would have been centered on private consumption and could have spread from there to investment. It would not have been necessary to reduce credit to the enterprises to leave room for credit to the Treasury. To achieve these results, the increase in taxation, during the period under consideration, would have had to be in the region of 4,500 billion lire. If, having expanded exports to the maximum allowed by the trend of foreign demand, balance-of-payments equilibrium had been obtained by limiting imports, domestic demand in real terms would have had to remain the same as in 1972, national income would have increased by 2 per cent.

The above considerations prove that the process of adjusting our balance of payments is not an impossible one, but it is certainly a painful one when it must be carried out through an overall limitation of demand. It is all the more painful, the more disequilibrium is the result of a deterioration in the terms of trade; but this does not mean that the adjustment should not be carried out.

Since the necessary reduction in real income is smaller, the greater the possibility of reducing the propensity to import with selective provisions, it appears that the rational basis of the recent provisions has been proved.

The introduction of a 50 per cent compulsory deposit on imports of certain goods accentuates the reducing effect of the balance-of-payments deficit on the monetary base. While a restrictive credit policy is in act, this effect is not offset; therefore it affects demand.

With a reduced supply of foreign goods, there should be a correspondingly slacker demand as a result of the credit squeeze. The compulsory deposit of 50 per cent of the value of imports, which practically results in the importers having to underwrite a public loan, reduces the dangers of excessive monetary base creation. If the imports are made, the deposit increases the Bank of Italy's power to control the overall volume of credit. If the imports are not carried through, the need for that control is lessened by the fact that the credit squeeze in act has alone helped to reduce the balance-of-payments deficit. If the balance-of-payments deficit falls as a result of credit granted by foreign exporters to Italian importers, the advantage obtained is short-lived; with this in mind, we introduced measures prohibiting the banks from granting guarantees to firms exporting to Italy.

Our balance-of-payments crisis is the most serious aspect of a wider crisis which was set off by the increase in the price of oil. We must not cease to collaborate in all the international organisations in order to obtain price relationships between oil and industrial products which make it possible to eliminate the balance-of-payments disequilibrium, while ensuring that it is financed during the period necessary for making the adjustment. During the adjustment period one could experiment with setting up an international agency to buy collective supplies of oil; collective guarantees for loans to be taken out during that period might make it easier to run such a scheme. Meanwhile, until some solutions are produced, demand-management policies using monetary instruments are becoming widespread and are at the root of recessionary impulses. The introduction of import quotas for oil products and their extension to non-oil products could become inevitable.

At the beginning of the year, the deficit of the government sector was estimated at 9,200 billion lire for 1974. This deficit was linked to a balance-of-payments deficit near the 5,500 billion mark; but a deficit of this size is unbearable. The European Economic Community recommends that we rapidly reduce it and gives a ceiling of 2,000 billion lire for 1975. In order to achieve this objective, the EEC recommends that we limit overall financing to the economy to a considerably smaller figure than the 22,400 billion stated in the letter of intent which the Italian government sent to the International Monetary Fund. To this effect, the EEC urges the reduction of the Treasury deficit and of its financing through the creation of monetary base and a sharp cut in the deficits of the local authorities, social security institutions and autonomous agencies; taxation must increase and the tariffs for public services must be raised when they operate at a loss.

We are encouraged to accept the suggestions of the EEC by the urgent need to keep the balance-of-payments deficit within limits which allow it to be financed by using credit lines, so far untouched, with the International Monetary Fund and the central banks, as well as possible long- and medium-term loans on the international market to be used to repay short-term loans.

The EEC Council and Commission have accepted the reasons given by the Minister of the Treasury which point out that the compulsory deposit of 50 per cent of the value of imports was an absolute necessity. But they insist that these provisions be rapidly substituted by others, aimed at regulating overall demand. The need to make this substitution is undeniable; however, both we and our European associates must be well aware of the consequences. To take even gradual steps, in 1974, towards limiting the balance-of-payments deficit to 2,000 billion in 1975, forces us to take immediate steps to curb demand. The present, and possible future, economic situation on the international markets leads one to believe that the adjustment must be made more by slowing down imports than by increasing exports. After all, we cannot move towards payments equilibrium at a time when the international economic situation is characterised by a fall in activity without domestic demand also falling.

In order to pursue, during the present economic deficit to 3,000 billion a year, it would be necessary, according to our calculations, to reduce domestic demand in real terms by between 4 and 5 per cent compared to the 1973 level. The balance-of-payments developments of the first half of the year would indicate that a greater reduction in overall demand is required. However, since the initial effect of the reduction would itself create the right conditions for a further reduction and thus allow the adjustment to be made, it seems sufficient to limit the reduction to the extent mentioned. Were we to attempt to bring about this reduction through additional taxation and were the amount of this taxation limited to 2,000 billion, it would be necessary to integrate the effects of such action by resorting to a credit squeeze. The increase in bank loans should be about a quarter lower than originally estimated; the impact would be distributed between investments and consumption.

Were it suggested, instead, that we aim at limiting the balance-of-payments deficit within the above-mentioned figure and reduce the negative impact on investments, taxation would have to amount to 3,700 billion.

In both cases, the gross national product in real terms would be one or two percentage points below that of 1973.

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In the past, in these same rooms, we stated that it is not the duty of the Bank of Italy to say in which ways taxes ought to be increased. But it is one of the Bank's tasks to make it known that, should one wish, as stated, to reduce the balance-of-payments deficit by fiscal instruments, there is no avoiding an increase in personal income tax which would also apply to those in the main income brackets. Over the short run, a hefty rise in revenue from taxation is obtained only if the higher taxation also affects these incomes. It is not enough to increase value-added tax on luxury goods; the increase should vary according to the goods and cover the whole range of consumer goods, with the resulting price rises being temporarily left aside when calculating the increment of the escalator clause. To believe, and to make others believe, that it is enough to increase the taxation on the highest income brackets is equivalent to deceiving oneself and others. Nor can we accept the argument that the taxation manoeuvre would be hampered by the present transition to a more modern tax system. What is done in other countries can be done in ours.

One does not defend the external solvency of Italy by pandering to the opinion of the majority. Defence of solvency, on which the continuity of the productive process depends, forces one to resort to monetary instruments, despite being aware of their negative effects on the system's capacity to produce income. If the Treasury deficit remains unchanged there must be a move towards new methods of financing it, which entail less monetary base creation. Firm in this belief, the Treasury has decided to offer the banks and the Bank of Italy (which will also place them with the banks) ordinary bills at the deferred rate of 15.32 per cent. Depending on the degree of success of the attempt to finance the Treasury deficit with non-monetary means, the smaller flow of monetary base to the banking system will limit the amount by which credit can expand. The quantitative limits on the expansion of credit to the public authorities are aimed at defending the percentage allocated to the enterprises; but these limits will be ineffective unless something is done quickly to reduce their deficits. The adjustment of public service tariffs is one of the necessary conditions.

Despite attempts to lessen the impact on the enterprises, the credit squeeze aggravates their situation and, in some cases, leads them into financial difficulties. It causes the public authorities to carry out rescue operations and this helps to expand the sector, which gains access to credit with an arrogance based on the guarantee inherent in the right to coin money. The introduction of subsidised prices would add new difficulties to those mentioned: transferring to the government the losses resulting from such prices would face us again with the dilemma: to finance the larger deficit by increasing monetary base and thus put up with the effect on prices and on the balance of payments; to finance it with bank loans and thus have less available for the enterprises. On the other hand, while prices are rapidly increasing, the adjustment of subsidised prices is made through a contraction in supply in real terms followed by sudden price rises. This is not a time to use expedients, but a time for serious decisions in the area of wages and taxation. Recourse to monetary instruments to defend the country's solvency answers a dire necessity; to have to carry out such a manoeuvre is an ungrateful task; the Bank of Italy is doing so resolutely.