Concluding Remarks for 1974

During 1974, the margin of uncertainty in the international and domestic economy widened and the likelihood of misjudged economic and monetary policy decisions increased; consequently, not only was the relevance of these policies constantly reassessed, but they had frequently to be modified in the light of changed conditions. Consultations between the Treasury and the Bank of Italy have become more intensive and within the Bank itself the staff of the various departments have taken part in a continuous study of current problems from all angles; finally, the head office and the branches of the Bank have been collaborating more closely. Today's meeting offers us the opportunity to describe the decisions we have taken and explain the motives behind them, thus enabling the public to make a critical assessment of the authorities' behaviour.

In last year's Concluding Remarks, I stated that current and foreseeable conditions on the international markets suggested that a reduction of the country's balance-of-payments deficit would be achieved through a slowdown in imports, rather than a speeding up of exports. While world economic activity was on the decline, we could not have moved towards equilibrium unless domestic demand followed a similar pattern: real gross national product would have been lower this year than in 1974 and possibly even than in 1973.

In a succession of public statements, I reiterated my belief that the economies of the industrial countries would be severely hit by a recession, and that this recession would probably worsen without timely measures to support demand, co-ordinated within international organizations.

The International Monetary Situation

Since last year's meeting of shareholders, little progress has been made in the field of international co-operation. One of the reasons for

this has been the pursuit of economic policies all simultaneously aimed at a rapid elimination of oil-related balance-of-payments deficits; these policies were pursued despite warnings by international organizations that the result would be to aggravate the recession.

The sudden change-over from traditional current account surplus to large deficit produced the inevitable reaction in businessmen and the authorities in the group of industrial countries. Those countries which, despite everything, ended the year with a current account surplus or only a small deficit owe this not only to the fact that they started off in a better position than others but also to the authorities' determined action to counter the prospective worsening of their external payments position. Among the major industrial countries, West Germany doubled its surplus; among those that have set themselves the target of eliminating their oil deficit within a year or two may be counted about half the main industrial nations.

In fact, a number of countries ignored the unavoidable conclusion reached immediately following the rise in oil prices: that, since the oil-exporting countries' capacity to import, despite a rapid expansion, was not and for some years yet will not be sufficient to absorb the oil surplus, if an implosion of economic activity was to be avoided then the oil-importing industrial countries would only be able to restore current account equilibrium over the medium run.

This cautious attitude was partly dictated by the difficulties experienced in financing the deficits from the very start. The quadrupling of oil prices has blasted open a vacuum in international payments into which massive flows of funds are poured. A year after the price increase, the oil-exporting countries had more than tripled their foreign currency reserves, which at end-1974 amounted to nearly a third of the world total. What was needed was far-sighted plans to enable the international monetary system to cope smoothly with the financing of the oil deficits. The first requirement was and is co-ordination of the parts played by the market and by the authorities, and a shift to long-term financing.

The need for such plans arose at a time when international economic co-operation was beset by many problems. It is within the framework of such co-operation that a clamp down should be placed on the excessive power, influence and pressures exercised at the international level by oligopolistic structures.

The well-meaning pronouncement that countries in a strong creditor position and those in a marked debtor position should share the burden of making symmetrical adjustments has not yet been translated into practice. With countries frequently pursuing conflicting targets, the outcome was official inaction. Most of the financing burden was borne by the market and its institutions, which had to accomplish this task amid growing tension, affecting both themselves and their debtors. The fact that countries in payments difficulties were obliged to concentrate their deficit financing on the markets only added to these tensions and helped to arouse fears of insolvencies. These fears in turn tended to transform the vacuum in the system into national vacuums that the weaker economies were unable to fill. In such a climate, there was little room for a calm consideration of the problems that would give due weight, on a national level, to the use individual countries intended to make of the funds lent them and, in a broader context, of the longer-term consequences of a situation in which the relative prices of industrial products and oil were frozen at the same level as at the start of 1974.

The conflict of views over the problems raised by the higher oil prices and over possible solutions came into particular prominence during the debate within the International Monetary Fund concerning the renewal of the oil facility, financed primarily by the oil-exporting countries. Some industrial countries, in particular the United States, rejecting the idea that the balance-of-payments adjustment process should include a distinction, over the short run, between the oil and non-oil deficits, opposed the renewal of the facility and succeeded in having strict limits introduced. This attitude in all probability stemmed from the conviction that the best course would be to refuse to adapt the international monetary system to absorb the impact of the payments disequilibria produced by the rise in oil prices so that the exporting countries would be obliged sooner or later to lower the prices.

Whereas on the one hand it was hoped to bring about a reduction in the price of oil, on the other an agreement on a minimum import price was proposed in order to encourage the development of alternative energy sources. However, the suggestion brought objections from those who believed that a minimum import price would prevent market forces from restoring relative prices to levels consistent with balance-of-payments equilibrium. At the same

time, it was agreed that the oil consuming countries should devise a plan for mutual support to ensure that the weakest among them would survive the adjustment phase. This was the approach adopted in the agreement reached within the OECD, but the original plan was radically transformed during the subsequent debates so that what emerged resembled a pact of mutual mistrust rather than one of mutual support.

The agreement is based on contributions of funds so conceived as to exclude the oil-exporting countries; the United States' contributions would result in the creation of additional dollars and would consequently help to weaken that currency on the foreign exchange market; West Germany would provide a guarantee for loans raised on the Euro-dollar market, even though her central bank already holds 22 billion's worth of dollars. Clearly, the notion that the OECD fund should strengthen the front of the industrial countries against the oil-exporting countries raises doubts about the effectiveness of any measures aimed at persuading the latter to lower the oil price; it also keeps the liquid funds flowing into these countries free from constraints and feeds uncertainty on the foreign exchange market.

At the various debates on the problems of the international monetary system and its adaptation to the rapid chain of events, the European Economic Community's contribution has not always been consistent with the aim of fostering balanced economic development in member countries. It was some time before the Community bodies were convinced that policies which aim at balance-of-payments equilibrium over the short run, without differentiating between the oil deficit and the non-oil deficit, lead to a recession. Commission members have taken it upon themselves to announce huge Community loans to finance the deficits of the countries in worst difficulties and to some extent have thereby helped to weaken the credit standing of the potential borrowers.

Discussion on the Community loan to be placed both with the oil exporters and on the Euro-dollar market ended in February this year. The original amounts were cut, and access for potential borrowers was made subject to a number of conditions. The Community was to arrange the loans on the international market after one or more members had filed a request, and only for the amounts required. The intention was to finance the deficits of the individual countries rather than that of the Community as whole vis-à-vis the rest of the world. The principle of solidarity, which was to have

inspired the loans, seems to be giving way to that of leadership by the dominant economies.

While the general increase in prices has swollen the value of world trade and the rise in oil prices has inflated the deficits to be financed, there has been an insufficient increase in liquidity, whether or not subject to conditions, through official channels. Moreover, it has not been distributed rationally, but has been concentrated in the countries least in need.

Most countries have agreed that gold should be demoted to the status of an ordinary commodity, and the official price abolished. The United States and the developing countries have opposed the mobilization of gold frozen in the central banks' reserves through the purchase and sale of the metal at a market-related price. Despite much insistence on the fact that special drawing rights would become the pivot of the reformed monetary system, no more were created; they were considered unnecessary because of the supposed "merry-go-round effect" which increases liquidity by recycling back into the deficit countries the dollars transferred to the oil exporters; although Italy and certain other countries raised objections, agreement was reached on an inadequate increase in IMF quotas. In the absence of official action, liquidity had to be increased through private channels, thus weakening the incentive to subject the latter to effective control.

Each of the oil-importing countries might have registered deficits vis-à-vis the oil-exporting countries which would have corresponded to the latter's balance-of-payments surpluses. In other words, the disequilibria might have been corrected by exporters accumulating credits denominated in the individual currencies of the importing countries. As an alternative to this, most of the oil-exporters' surpluses might have been financed with the monetary instruments of the deficit country issuing their preferred currency. The monetary circuit would have been closed by the growth of this country's short-term indebtedness: this would in effect have meant a liquidity deficit in the United States' balance of payments.

In 1974, the deficit took the form of a 24 billion dollar increase in the United States' short-term liabilities. This increase has to be added to the 25 billion rise in the xenomarkets' short-term liabilities, excluding interbank operations. The sum of these two figures is a measure of the growth of the liquid dollar balances of the rest of the world; compulsory use of the dollar increases its instability and impairs its status as an international currency.

In 1974, the overall expansion of official reserves amounted to about 20 per cent, while the xenocurrencies, taken net of interbank accounts and accounts held by official authorities so as to avoid doublecounting, expanded by 6 per cent. By calculating the ratio of world trade to these two aggregates we obtain an index of the velocity of circulation of international liquidity of 2.4, as against 1.9 in 1973. It becomes obvious that international money creation was inadequate as soon as one considers that the official reserves of the main industrial countries rose by barely 4 per cent; furthermore, these reserves have tended to be concentrated among those countries with a current account surplus; the others contracted international debts amounting to some 15 billion dollars.

The complex of pressures described above helped to push interest rates up to unprecedented levels, especially in the short-term sector, making it more costly to finance the oil-price rise and more profitable for the oil producers to keep their revenues in liquid form: so from a monetary standpoint too there was a disincentive to spending oil surpluses and investing them at long term.

The failure to adapt official reserve instruments to the increased requirements of world trade set in motion a vicious circle in which dollars had to be created through a liquidity deficit in the US balance of payments; there was a greater tendency to convert dollars into other currencies; the currency weakened. Moreover, for reasons that had nothing to do with the United States' basic balance-of-payments position, there were massive transfers of dollar assets. Exchange rates fluctuated violently: between March 1974 and March 1975 the Deutsche Mark and the Swiss franc appreciated vis-à-vis the dollar by 13 and 25 per cent respectively.

The instability of exchange rates brought many banks into serious difficulties, mainly because it led to speculative operations, often in violation of the regulations. After only a few months, towards the middle of last year, many banks, and not all of them small ones, suffered huge losses on foreign exchange transactions, which in some cases led to insolvency. The large banks operating on the Euro-market reduced deposits with and credit lines to the smaller banks, especially those of countries in a weaker financial position. This did much to undermine confidence in small- and medium-sized banks, with the result that deposits were transferred to the large ones. The liquidity crisis which thus hit many of the smaller banks handicapped the Euro-markets, partly because certain large banks, holding

the bulk of Euro-deposits, found that the high ratio of liabilities to capital and reserves left little scope to increase lending.

The United States' monetary authorities were apparently indifferent to the trend of the dollar rate on the foreign exchange markets. On a few occasions, they intervened to moderate the size of fluctuations, but in no way was this action designed to defend an exchange rate compatible with market equilibrium. Therefore, in order to maintain orderly conditions on the foreign exchange market the EEC monetary authorities agreed to co-ordinate interventions in dollars. However, they formulated no medium-term policy with respect to the dollar, instead resigning themselves to whatever action the United States and dollar-holding countries decided to take. In view of the improvement in France's economic position, the authorities announced their intention to take the franc back into the joint currency float. All these events demonstrate that it would be advisable to extend the area of stability; however, this would not survive for long without a sound basis in co-operation and co-ordination. We have said what this entails during various debates over the last few years; among other things, a commitment to pursue concerted policies with regard to the dollar.

Substantial progress must be made towards economic unification if the European currencies are to acquire greater stability. Economic unification could be part of the process of building a new world order based on co-operation and more widespread prosperity. If economic weight, and the power that goes with it, is to be redivided among countries and groups of countries that have previously accepted the key position occupied by the US economy since the war, then those countries must accept the responsibilities of leadership, even though this entails sacrificing, in the short run, both ambitions and national interests.

In near-crisis conditions, the problems of leadership are usually solved by handing over the task to the country with the greatest economic and political weight. This is not necessarily the best solution for countries which have reached a high degree of maturity and civilization and whose economies are moving towards a balanced, polycentric system. Collective leadership is in fact a sign of considerable maturity and can be as efficient as leadership by a superpower. It is the absence of leadership that is so damaging to the system during a serious crisis and that leads to dangerous instability.

Over the last few months many countries, including the United States and West Germany, have begun to reflate with the help of fiscal, monetary and credit policy instruments; monetary and credit policy played a particularly important role during the attempt to slow down the rise in costs and prices. The possibility of a recovery of productive activity around the end of this year and the beginning of next and the expected further slowdown of the price spiral make it appear not unlikely that the present acute cyclical difficulties will be overcome by then. However, looking further ahead, there is no doubt that the trend of the world economy will be influenced by the domestic and international structural problems that are still unsolved.

The domestic problems, which are above all the responsibility of the individual countries, will be discussed later: however, it should be said here that the greater each country's progress towards solving its own problems, the greater will be its contribution towards solving international problems. There can be no lasting reform of the international economic and monetary system unless stability has been restored within individual countries. While these continue to have difficulty in solving their own domestic problems, there will be a tendency to bend international trade and monetary policy instruments towards that end. By definition, optimum use cannot be made of these instruments if their international repercussions are ignored.

The monetary and economic system established at Bretton Woods and under other post-war agreements had become so politically and economically obsolete that it could no longer make any contribution to the balanced growth of the world economy. However, a new order, in which prosperity and progress are sought along lines such as East-West trade and the development of what have hitherto remained marginal areas, cannot be built by destroying the present network of multilateral relations. This network has integrated undersized national markets into a market which, though not world-wide, has freed us from the bilateralism of the 1930s and late-1940s. But we could well be pushed back into bilateralism by the increased instability of the world economy.

A widespread relapse into bilateralism cannot be avoided merely by preaching eternal devotion to a system based on the one in existence for the past twenty-five years: we must begin to reconstruct with patience and tenacity. As some of those working on the reform of the international monetary system have already realized, our ability to construct a new system will be put to its greatest test by the

problems of the so-called interim period. The results will be more fruitful if the authorities are sensitive to, and co-ordinate, the signals of the markets.

On previous occasions, I have emphasized the fact that the distances separating the monetary authorities from the markets have narrowed, both on the theoretical level with regard to the optimum structure for the international monetary system and on the practical level. This has been partly due to greater dependence on the market for deficit financing. In the absence of controls, the market itself has experienced the disequilibria typical of an unregulated banking system and has called for intervention to control liquidity. The demands of international bankers have almost exclusively taken the form of requests to the authorities to fulfil the role of lender of last resort when deposits are suddenly shifted for reasons unconnected with misbehaviour by any of the banks. But, at the same time, the bankers have continued to insist that it would be unwise to extend the rules applying to national banking systems to the Euro-market, arguing that, since there will always be unregulated areas, the market will switch to these, the present financial centres will lose their primacy and the efficient management of foreign currency funds will be jeopardized. The narrower spread between lending and deposit rates on international markets compared with national markets has been put forward as proof of this efficiency.

These arguments become contradictory when the cry is raised for last-resort liquidity while denying the authorities responsibility for deciding to whom, how much and for what purpose the funds should be lent. The problem is not only one of helping banks in difficulty, but also of deciding whether to raise the amount necessary to prevent a crisis of confidence from the market or among other banks. Nor do these arguments reflect the true situation, since there are in fact instruments capable of halting shifts of deposits from the regulated to the unregulated area.

The authorities continue to hold contradictory views on international liquidity: on the one hand, they consider that only official reserves, that is the financial instruments that they themselves hold (gold, special drawing rights, IMF position, dollars and other currencies), constitute international liquidity; on the other, they persist in regarding the international foreign exchange market as extraneous to the equilibrium of their own reserves and currency parities and are firmly convinced that management of the Euro-

markets and, more generally, of the xenomarkets is primarily the responsibility of national authorities. This attitude does not reflect the conditions in which the authorities and the market where all the different financial instruments co-exist actually operate; nor can the market conditions of one instrument alter without repercussions on others, and thus on the preferences of the monetary authorities.

The success of the reform depends on a programme of official action that covers all financial instruments and is capable of being adapted to changing cyclical conditions. Within this framework, the amounts of quotas and special forms of credit in the International Monetary Fund, the price of gold, the volume of special drawing rights and dollars would be determined in a co-ordinated manner. This seems to be the lesson to be drawn from the events connected with the rise in oil prices, which have led to many debates and which only appear to have taken us further away from a reform of the international monetary system. These events have brought to light the weaknesses in the present system and have helped to push the international community towards a negotiated solution: however, we must approach this with a clear mind.

It has not been possible, during current negotiations within the IMF, to formulate the goals to be pursued in a situation so profoundly changed. According to the United States, recourse to floating exchange rates should be embodied in the new system; others maintain that orderly trade and international payments must be based on fixed parities, even if these are subjected to more frequent adjustments. It is generally agreed that international liquidity should be adjusted through special drawing rights on a basis that would help to promote balanced economic growth. The poorer countries should receive a larger share of world resources; but instead their hopes are answered with an endless succession of committees and sub-committees.

Each of these subjects has been dealt with at length in past Reports. We have called for reasoned solutions to the position of special drawing rights and gold in the international monetary system and have worked to put them into effect. The Deutsche Mark, followed by other currencies, has been defined in terms of SDRs; a new European unit of account has been approved, one which can, in time, be put to wide use; gold, no longer the system's numéraire, has become a store of value and it has been possible to use it as collateral. Despite the enormous rise in the free-market price of gold, the

international monetary system has reduced its dependence on the metal and has latched itself more closely onto special drawing rights; but the refusal to adapt the quantity of SDRs to the increased financing requirements and the retention of present limitations on their circulation calls into question the persuasive power of the reasons behind their original creation.

Within the international organizations we have attempted to trace, through analysis, the economic trends, which now involve a far more complex interpretation. A look back at the opinions expressed within some of those organizations, such as the EEC, shows how quickly attitudes change and, consequently, how difficult it is to adapt national policies. At the end of 1973, the most salient feature of the economic situation was an acceleration of the rise in prices; expanding world demand was straining the productive apparatus; the fight against inflation had priority over all other targets; to win this fight demand had to be curbed. The symptoms of the situation were diagnosed correctly, but the economic policy then formulated was bound by a 1960s-style interpretation of the picture. Measures were proposed as if the terms of the problem had never changed and it was expected that the old mechanisms would ensure that equilibrium would be restored.

The energy crisis has made economic problems more complex and the outlook more confused. It is generally acknowledged that, if the increased cost of energy sources is to be absorbed, economies must be restructured; for this private consumption must grow at a very much slower rate than GNP and an active social policy must be pursued. EEC economic policy therefore stands in need of a medium-term strategy, though this is said to be solely due to the oil crisis.

But even before the oil crisis social groups within each country were pressing for a more active social policy to change the pattern of demand by curbing private consumption and increasing social consumption. Even in countries with fewer territorial and social disequilibria the quality of gross national product had become more important than mere expansion. The main objective was not the size of the growth rate but the search for more acceptable production methods and the orientation of production towards social needs, which the population was increasingly recognizing as a priority. Community bodies undervalued the importance of a medium-term economic policy because of the political constraints, both explicit and

tacit, that conditioned their activities. An approach to structural problems requires a willingness to adopt supranational criteria and a commitment to accept burdens that in the short term seem to benefit only a few countries. Only in this frame of mind could a critical analysis of economic developments in the Community since it was set up have stimulated the kind of imagination needed to look beyond the present and stake on the future.

Instead the cyclical approach prevailed and, because real causes were not sought, forecasts were all too easily swayed by wishful thinking. No one noticed that the worst recession since the war was about to begin. Only from the autumn onwards did reports on the state of the Community economy pay due attention to the worsening of the situation: they expressed surprise at the worrying delay in the recovery of the United States; they noted that stagnation had also begun in France and West Germany. At the beginning of 1975, the statistics revealed the extent of the production fall-off in almost all industrial countries; the likelihood of a recovery, in the United States as well as in West Germany, the Netherlands and France, was set further and further ahead, at the very best by the second half of the year; forecasts on the growth of EEC income were revised downwards each month; the reabsorption of unemployment took its place alongside the fight against inflation among economic policy objectives.

For the first time since just after the war, the industrial countries suffered a drop in economic activity. Among the major European countries, West Germany registered a particularly severe slowdown in domestic demand during 1974. Since the volume of Germany's foreign trade is only slightly less than that of the United States, and her trade with other European countries twice as large, fluctuations in German economic activity are the most important single external factor for the economies of the rest of Europe.

During the first few months of this year, the unemployment figure for the industrial countries rose to over 15 million. It would have risen even higher had it not be kept down in some countries, and especially in Italy, through a system of reducing working hours in order to spread the burden of adjustment over large sections of industrial manpower. The result was that the recession was less harsh for marginal workers; however, social and political tensions, fuelled by inflation, give cause for concern.

The resistance of the present crisis to fairly rapid cure by stabilization policies is due to the relative weight of structural factors. More and more social groups and sectors of the economy have managed to surround themselves with a protective screen, thereby enlarging the areas of rigidity that obstruct the adjustment process and make it more costly. The elimination of the general excess demand that had characterized the industrial economies until the turn of 1973, and the subsequent weakness of global demand, as reflected in the drop in capacity utilization, have not eradicated inflation. Because of the large structural component of inflation a micro-economic approach is required, and success will depend on a co-ordinated programme of action over the medium term.

In most industrial countries, the time lags before monetary policy took effect were especially long, mainly because many economies held abundant liquidity when restrictive measures were introduced between the end of 1972 and the start of 1973. This was due to the extensive creation of international liquidity over the period 1970-1972 and to the expansionary domestic monetary policies pursued by many countries for most of this period. It is reflected in a much higher liquid assets/income ratio than the normal medium-term trend among both enterprises and households. The net liquidity position of the former in particular reached a fairly high level in 1971-1972 and was subsequently held there by profits swollen by rapid and inflationary cyclical expansion.

The leading industrial countries continued to pursue restrictive credit policies during the first half of 1974, in some cases tightening them even further, despite the cyclical turn-around and the marked slowdown in investment in real terms. The reasons for this were not only the priority given to balance-of-payments equilibrium but also the difficulty of finding the correct policy dosage on the basis of the usual monetary indicators in a period of strong inflation, widespread inflationary expectations and rapidly changing relative prices. A further factor was the under-estimation of recessionary tendencies, either latent or already apparent, on which some international institutions based their efforts to persuade deficit countries to rapidly restore equilibrium.

It was against this international background that Italy took steps to restore balance-of-payments equilibrium and curb inflationary pressures.

In May last year, the balance-of-payments deficit, excluding compensatory loans, amounted to over 6 billion dollars. The annual rate of increase in wholesale and consumer prices during the three preceding months worked out at 58 and 24 per cent respectively. There was no possibility of access to the international capital market because the country's indebtedness already stood at some 10 billion dollars; we had drawn the whole of the credit facility granted by the EEC under the short-term support arrangements; the only possibilities still open to us were the IMF credit line and, perhaps, the oil facility.

In this solitary situation, Italy clearly had no alternative but to pursue resolutely an autonomous policy that would save the economy from insolvency. The international and domestic press were convinced that bankruptcy was the inevitable outcome and only speculated as to when it would happen.

In the first four months of this year, the balance of payments on a cash basis registered an autonomous surplus of around 100 million dollars. Over the same period, we reimbursed compensatory loans amounting to 400 million dollars, repaid 500 million of the Bundesbank deposit and drew 378 million dollars on the IMF, thus using up the remainder of the 1,214 million dollar credit line; in addition, interest payments totalled about 400 million. In May, intervention on the foreign exchange market brought in several tens of millions of dollars and there was a further reduction in the external debt. During the three preceding months, the annual rate of increase in wholesale and consumer prices came to 3 and 12 per cent respectively.

As we said in last year's Report, there was bound to be a slowdown in economic activity; however, in the first quarter of this year industrial production held steady only slightly under the level of the fourth quarter of 1974.

The overall foreign position of the monetary institutions, including compensatory loans, appears to be in balance if gold is valued at the reference price of 149 dollars per ounce used in the crossed deposit operation between the Bank of Italy and the Bundesbank. Following the conversion of the EEC short-term support into medium-term support overall liabilities, totalling 15 million dollars, are now almost exclusively medium- and long-term.

The balance-of-payments deficit on current account has been reduced to proportions which we should be able to finance through

autonomous capital movements and credit granted by international institutions. In other words, we have achieved our aim of preserving Italy's external solvency.

Estimates of the 1975 deficit have recently been revised downwards but the figures are still large. The improvement in the balance of payments can be attributed to the drop in import volumes and the fall in prices for many industrial raw materials and some foodstuffs; the slackness of foreign demand limits prospects of an improvement in exports. A recovery of domestic economic activity, even though centered on sectors with a relatively low import content, will inevitably stimulate purchases from abroad; the balance-of-payments constraint will then make itself felt in full force unless it is tempered by a growth of exports, and this presupposes that costs and prices are competitive. In order to offset the oil deficit, the surplus on trade in other goods and services will have to reach an equivalent of 4.5 per cent of national income; a surplus of this order was achieved in the 1965-1968 period when world demand was strong and our exports were steadily increasing market shares.

The Domestic Monetary Situation

In Italy, as in other industrial countries, the cyclical turnaround was due to the direct and indirect impact on demand of the rise in prices for oil and other raw materials and the economic policy measures introduced to restore balance-of-payments equilibrium. Prices of imported goods, 40 per cent of which consist of raw materials and energy sources, rose much more than prices of exports, mainly manufactured goods. Had the volume of trade in goods and services shown no change from the previous year, the deficit would have worsened by nearly 5,000 billion in 1974, to total 7,500 billion.

The worsening of the terms of trade led to a wide discrepancy between the increase in implicit prices of domestic consumption and investment (21.6 per cent) and that in implicit prices of gross national product (16.6 per cent). At constant prices, gross national product rose by 3.4 per cent, not enough to fill the gap: the purchasing power distributed to the factors of production declined by 0.8 per cent. This contributed to a marked slowdown in domestic demand, which rose

by 1.7 per cent at constant prices, compared with 7.3 per cent the previous year.

That part of the increase in national product not absorbed by domestic demand was transferred abroad, reducing the deficit in real terms and thereby holding down the deterioration in the balance on goods and services to something over 3,000 billion. The decline in the purchasing power of domestically distributed income involved both households and enterprises; partly because of increased taxation, households' available income fell by 2.4 per cent; there was also a drop in real terms in non-financial enterprises' gross profits, owing to the hefty increase in prices of capital goods.

The deterioration in enterprises' profit and loss accounts over the year, along with the accumulation of stocks of finished products, kept credit demand high even beyond the end of 1974, when aggregate demand and production were already falling back, so that short-term interest rates were slow to fall. In particular, the already large share of total financing taken up to cover the deficits of the public utility agencies and enterprises continued to increase, owing to the negative repercussions of inflation on those sectors whose prices are slower to adjust to changing economic conditions.

During the first half of 1974, the decisions of enterprises and households were influenced by expectations of runaway inflation. Enterprises continued to invest heavily in fixed capital and began to rebuild inventories, also acquiring financial assets abroad; when credit was tight they drew on their cash balances. Households endeavoured to alter the composition of their wealth, turning to real-estate and other shelter goods, thus forcing up prices; within financial wealth, there was a more marked preference for liquidity; the propensity to consume rose.

Uncertainty as regards anti-inflationary policy and the modification of the policy of bond price support heightened fears of a loss of purchasing power and of a drop in bond prices: capital market disequilibrium reached huge proportions. Despite rationing of new issues and compulsory portfolio investment by the banks, equilibrium could only be restored through a rise in interest rates; this increase took place between March and November.

The shifts in the allocation of savings made it impossible to meet Treasury financing requirements with non-monetary means; in order to retain control over monetary base creation, the authorities introduced new instruments to mop up the excess liquidity injected into

the system by the Treasury. Partly in fulfilment of international commitments, as the erosion of monetary base through the external deficit began to slacken, the monetary authorities first placed limits on further bank borrowing abroad and subsequently sought to regulate the growth of monetary base and thus credit expansion through open market operations and central bank refinancing facilities. However, since monetary base control was felt to be an unsatisfactory means of regulating bank credit and directing its flow, it was decided to place a ceiling on the total growth of lending, retaining certain selective criteria, and to renew the banks' securities investment requirement.

During the first quarter of 1974, monetary base was contained through liquidity erosion by the balance-of-payments deficit and the repayment of part of the fixed-term advances granted to the banks in December. The issuing of Treasury bills would have permitted a tighter control over bank liquidity; but this would only have been possible if Treasury bill interest rates and official rates had been rapidly adjusted to the conditions necessary for market equilibrium, which were partly obscured by the policy of intervention on long-term rates.

During the second quarter, the dramatic deterioration of the balance of payments and the intolerable pressure on official reserves persuaded the monetary authorities to switch the emphasis of economic policy from income growth to curbing the external deficit. The Treasury's huge cash requirements, which could only be financed through monetary base creation, gave fresh fuel to domestic inflation and aggravated the balance-of-payments deficit, destroying any advantage deriving from the lira's depreciation.

The monetary authorities did less than in the past to offset the sapping of monetary base through the external accounts. In May, three-month Treasury bills were issued at a rate of 15.32 per cent, so that no new liquidity was created through the redemption of maturing securities.

Between February and May 1974, despite our intention to curb the expansion of monetary base, we continued to intervene extensively on the market to support bonds, though at steadily lower prices. This apparent contradiction arose because we felt that a slump in bond prices had to be prevented while increasing awareness of our deteriorating balance-of-payments position was causing savers to panic. Support was abandoned in June; despite the rapid rise of

long-term rates to levels obtaining abroad, the market was unable to achieve equilibrium because of uncertainty about the future trend of inflation and the course of monetary and fiscal policy. The increase in short-term rates was even faster: between the end of April and the end of June the rate on interbank deposits rose from 13 to 18 per cent. The joint effect of the balance of payments and the portfolio investment requirement caused a rapid drop in the supply of bank loans.

The introduction of the import deposit scheme acted as a further restraint on monetary creation. The growth rate of bank deposits slowed down even though the public had switched its preference to liquid assets.

So as not to absorb monetary base, no Treasury bills were put up for auction in June and July. In July, the banks asked the Bank of Italy for Treasury bills for investment of part of their excess reserves and repaid borrowings made from the central bank the previous month; short-term rates began to fall. The import deposit scheme was eased when the deposit on beef was reduced and certain agricultural products were exempted. The banks were requested not to increase their net foreign debtor position, partly in order to stem the loss of confidence in the Italian economy on international markets. In an attempt to increase the supply of financing to building, agriculture and exports the Inter-ministerial Committee for Credit and Savings decided to introduce new provisions regarding the placement of mortgage bonds and to adjust base rates on concessionary-rate credits to market conditions.

In August and September, the balance-of-payments results confirmed the improvement witnessed in July; the Bank of Italy aimed at stabilizing the overall amount of monetary base in the banking system; the banks repaid part of their foreign indebtedness and central bank liabilities and also purchased Treasury bills from the Bank of Italy in addition to those acquired at the monthly auctions; interest rates on the interbank market fell; there was some improvement in bond prices. The rising trend of rates on the international markets turned round, and since expectations were of slower demand growth, it seemed likely that this was more than a transitory development. We considered re-introducing the policy of support on the bond market but preferred to wait a few months more; the events of October justified our caution.

In October, in fact, against a background of political uncertainties, speculative capital movements gathered new momentum; despite massive Bank of Italy intervention on the foreign exchange market there was no way of preventing a depreciation of the lira, which continued through November. Monetary policy again became more cautious; demand for bank loans remained high; interest rates on the interbank market started to rise again; all rates were moving upwards. These developments, combined with persisting uncertainty on the capital market, reinforced the public's preference for bank deposits. Long-term rates touched exceptionally high levels.

At the end of October, the import deposit on beef was lifted; by early November the scheme had been in operation for six months: because of exemptions introduced during the early months, the net effect of the import deposit scheme was to inject monetary base into the system, initially for around 100 billion per month. During the first half of November, speculative movements continued to exert considerable pressure on the foreign exchange market. Against this background, one issue of three-month and one of one-year Treasury bills were made, at 15.32 and 15.61 per cent respectively: purchases by the banks at auction and directly from the Bank of Italy brought their liquidity back within the desired limits.

During the second half of November, the lira exchange rate steadied, even with greatly reduced Bank of Italy intervention on the foreign exchange market; in addition, there was growing evidence of a slowdown in wholesale price increases as well as an easing of demand for short-term credit. In December, monetary policy was given a more expansionary slant, even though the balance of payments was still in deficit. No Treasury bills were issued; increased refinancing facilities were made available to the banking system; authorization was granted to deposit 300 billion's worth of mortgage bonds for compulsory reserves against withdrawal of the same amount of cash; at the same time, the figures set for the compulsory import deposits were reduced. Towards the end of the month the Committee for Credit exempted export credits from the ceiling on lending expansion and "unified" that on loans to productive enterprises, abolishing the individual ceiling in respect of the largest borrowers.

In early 1975, monetary policy was set more firmly on an expansionary course: the excess liquidity injected at the end of 1974

was only partially mopped up through the sale of Treasury bills by the central bank in response to requests from the banks. At the January auction, 500 billion's worth of Treasury bills were offered at a rate of 14.13 per cent; considering the substantial improvement in the banks' liquidity and the drop in rates on the interbank market, amount and price seem appropriate, but the auction was not a success. Since the banks purchased 610 billion's worth of Treasury bills from the Bank of Italy during the same month, it was clear that the system of issuing Treasury bills and Bank of Italy intervention needed reviewing in order to restore some weight to the quantity of bills offered at monthly auctions.

The reform of the compulsory reserves system was also undertaken in response to the need to increase the scope and effectiveness of this instrument in regulating the volume of credit and bank deposits. Modifications provided that only cash could be deposited as compulsory reserves, the same coefficients would apply to all banks and all categories of deposits, and compulsory reserves would be related to movements in deposits.

One of our major problems continues to be the provision of long-term financing for the public sector, for enterprise investment and for building. The main instrument available to the central bank, i.e. monetary base regulation, has been directed towards expansion. The decision of the Inter-ministerial Committee for Credit in March this year to abolish the non-interest-bearing import deposit requirement is in line with this course and will make it possible to gradually inject some 1,200 billion of monetary base into the economy. This policy was accompanied by provisions to support the recovery of the capital market and increase the banking system's operational flexibility.

To this end the monetary authorities decided:

a) to extend the portfolio investment requirement for six months, but in more flexible form, restructured in line with the reform of the compulsory reserves system;

b) to intervene actively on the fixed-interest securities market in order to curb short-run fluctuations and reduce the risks deriving from unstable market conditions;

c) to abolish ceilings on the growth of bank lending;

d) to encourage the fall in bank interest rates, giving priority in refinancing operations to banks losing market shares because of this. The recent reduction of official rates is also part of the same policy.

In the Concluding Remarks of the 1972 Report, I ended by describing the course of events that would follow a credit squeeze: "should it become necessary", I said, "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. Shouts of protest would again be raised ...". The introduction of compulsory securities investment for banks in June of 1973 was intended as a form of protection; the requirement concerned paper issued by the industrial credit institutions and was meant to ensure a sufficient supply of funds to the institutions to prevent a cut-back in credit at a time of heavy investment in plant.

The sheer size of the Treasury deficit and the need to finance it weakened the Bank of Italy's power to regulate monetary base and keep credit within the desired limits. Measures concerning the volume and allocation of credit were intended to reduce the balance-of-payments deficit and at the same time counter expectations of worsening inflation. The steps taken achieved this aim, but the price paid has been described in previous Reports. The credit squeeze, combining with an autonomous process of income contraction, accelerated this process but at the same time helped to restore our international credibility; it led to inflexibility and distortions in the structure of banks' balance sheets and in competition between banks.

The measures introduced between June 1973 and May 1974, against an international background in which the forces of coordination were weakening, reflect a move away from the conditions which had previously made it possible to pursue monetary policy in an orderly financial system. These conditions were broad equilibrium in the external accounts, a Treasury deficit that was kept within reasonable limits, and structural symmetry between enterprises' financial liabilities and households' financial assets. Savers and borrowers were making much the same choices concerning the duration of investments; conditions on the stock exchange and the existence of adequate margins of enterprises' savings encouraged participation in the risks and responsibility of industrial activity. In such circumstances it was possible to maintain the distinction between

short- and long-term credit, because maturity transformation by the financial system was kept within narrow bounds.

In such circumstances the Bank of Italy was also able to operate according to orthodox monetary principles: bank of banks, itself specialized in short-term credit, the central bank supplied the private sector with monetary base through refinancing of the banking system according to the needs of industry and commerce. The compulsory reserves system strengthened the link between monetary base creation and the formation of deposits and credit, while the need for authorization to issue bonds ensured control over the long-term credit institutions' fund-raising; monetary policy thus had at its disposal a harmonious set of instruments. The central bank was requested to intervene in pursuance of limited and well-defined targets in order to guarantee the internal and external value of the lira.

The opening up of international markets, the growing role of public-sector intervention in the economy, the sharpening of conflicts in the area of income distribution, and the preservation of real wages and salaries have radically altered the original framework, creating conditions in which economic and financial disequilibria are sharper and more frequent, while at the same time the corrective instruments available are less effective.

The value of foreign trade in relation to gross national product has risen from an average of 26 per cent in the 1950s to 31 in the 1960s, 43 in 1971-1974 and 54 per cent in 1974. The Treasury deficit, also measured as a proportion of gross national product, amounted to 4 per cent at the beginning of the 1960s; it dropped to an average of 2 per cent during the first half of the 1960s only to then accelerate to around 9 per cent in 1973 and 1974. The growing impact of these external factors on the credit system was accompanied by a radical change in the composition of the economy's financial assets and liabilities: bank deposits have risen in relation to total financial assets from an average of 29 per cent during the 1950s to 37 in the 1960s and 45 over the last four years; the proportion of short-term indebtedness in the economy's total financial liabilities has increased less rapidly, rising from 27 to 30 and 33 per cent respectively.

The balance sheets of the credit institutions provide a mirror-image of the disequilibria of non-financial enterprises. Given the institutional limitations on the banks' freedom to grant long-term

financing and public unwillingness to invest in securities, the following picture has emerged:

a) an increase in the ratio of securities portfolios to deposits, from an average of 13 per cent in the 1950s, to 21 in the 1960s and 29 in the last four years; conversely, a drop in the proportion of direct bank lending in total financing by the credit system, from 76 per cent in the 1950s to 70 in the 1960s and 68 in the last four years;

b) an increase in the proportion of lending to the public and private sectors financed from bank deposits; this ratio showed a falling trend up to 1971 but over the next three years rose from 78 to 83 per cent.

These changes in the banks' balance sheets have served to match the financial structure of deficit sectors to that of surplus sectors and have thus made it possible to meet public and private financing needs; without this, investment, income and employment would have grown more slowly. However, the counterpart of this service has been a decline in the banks' operational flexibility, the consequences of which are felt most severely in times of economic crisis.

During long periods of interest rate stability, it is less essential that a high proportion of deposits be invested in securities. Difficulties arise when interest rates are moving up, because the time it takes for the average yield on securities to adjust depends on the rate of portfolio growth and renewal, i.e. on the speed at which the proportion of securities purchases at the new market conditions increases whereas lending and deposit rates may adjust rapidly in response to the market's liquidity and bank competition. If the bond portfolio is large, then the average yield on the banks' balance-sheet assets is slow to adjust and consequently the banks' equilibrium is subject to stronger tensions: the bank that does not offer higher returns on deposits will suffer liquidity strains; the bank that attempts to match deposits to the demand for loans will be subject to profit and loss account strains. The size of the spread between lending and deposit rates has been influenced by the search for a margin that would cover the risks connected with bond price fluctuations, with the instability of the share of foreign activities and with doubts about the economic viability of debtor enterprises.

While the threat of the public sector was increasing and financial disequilibria were impairing the banks' flexibility in times of crisis,

and while the government, local authorities and semi-government agencies were meeting growing difficulties in achieving institutional targets, more was being required of the central bank and of monetary policy: the objectives were to include income growth, full employment, the correction of sectoral and territorial disequilibria and non-monetary financing of the public sector. It was becoming increasingly necessary to meet crises with emergency measures and with a policy mix that would attempt to reconcile the conflicting targets. The burden of these policies weighed more and more on the credit system and with each economic cycle the fluctuation of interest rates and the deviation of financial flows from their normal trends widened.

In 1973-1974, the circumstances in which the financial system confronted the crisis, and the credit policy measures introduced, brought about changes in the composition of bank assets different from those that had occurred during previous periods of monetary restraint – the proportion of securities in fact rose and that of loans dropped. The measures taken to give financial support to the recovery of investment and to protect the bond market were designed to ensure an adequate level of demand for securities from the banks and prevent the sale of existing portfolios. The proportion of loans in overall bank credit, equal to 76 per cent of the total outstanding at end-1972, amounted to 61 per cent of flows in 1973-1974; the spread between lending and deposit rates widened by about 4 percentage points, compared with one percentage point in 1969-1970 and 0.6 in 1963-1964. The sharp fluctuations in bond prices led to huge capital losses which were only partly entered in the profit and loss accounts.

The banking system's ability to adapt the net price asked for intermediation to the liquidity conditions created by monetary policy should be defended in order to ensure that the system continues to function smoothly. As in previous cycles, the system adjusted faster while rates were rising than while they were falling; it has again been observed that, in addition to the fact that credit is a necessary, but not a sufficient, condition of production and investment, there is another reason for the asymmetrical working of monetary policy. This is that the individual bank will not hesitate to increase deposit rates unilaterally but in no circumstances will it make conditions less favourable for the depositor unless its competitors agree to do the same; an agreement to reduce lending rates is not reached until the agreement to lower deposit rates has been put into effect, but the

central bank's liquidity policy may push deposit rates below the level agreed.

The existence of this mechanism has persuaded economists, businessmen and banks to propose a large reduction, or even the abolition, of present interest payments on current account bank deposits on the basis that other countries have done the same with demand deposits, which in some respects are a larger and in others a smaller category than our current account deposits. Interest varies from zero to the current market rate; the rate is fixed by law, under administrative measures or by voluntary agreement between banks. In cases where the interest rate is near zero external monetary markets have grown up, such as the Euro-dollar and Euro-mark markets, creating serious problems for the country's foreign exchange and internal and international monetary policies. In the United States, moreover, officially accepted markets and markets outside the control of the authorities have emerged. Recently the US authorities have proposed extending compulsory reserve requirements to these markets.

In previous Concluding Remarks, I have taken the view that lending rates determine deposit rates. The first factor is the customer's willingness to pay a higher lending rate. Then we have, as intermediate factors, the banks' ability to keep intermediation costs to a minimum and their willingness to give up profits in favour of increasing market shares. Finally, we obtain the rate paid on deposits. Recent experience has provided more information on the behaviour of credit demand; it has been observed that in the present Italian economic situation credit demand reacts less to increases in the cost of credit because of the greater weight of demand from sectors less sensitive to interest rates. Consequently, the banks, in an attempt to increase deposits by granting high rates to depositors, meet with resistance not so much from the drop in loan demand as from public opinion and accusations of usury. These accusations became more insistent when the banks, having noted the turn of the cycle, reduced the cost of fund-raising before they cut the lending rate, also giving some indication of the target deposit rate, with an immediate announcement effect.

Despite the drawbacks it has brought in other countries, the reduction or abolition of interest on current accounts and, more generally, on demand deposits may improve the efficiency of monetary policy in general, though not specifically for the purpose of

pegging lending rates. In Italy, two objections have been raised to this solution:

a) it is extremely difficult to ensure that the ban on banks immediately mobilizing tied deposits on request is observed; it would be easy nowadays to evade the regulation on an administrative level;

b) the introduction of discrimination between various types of deposit would have a large impact on the structure of the banks' balance-sheet liabilities.

Apart from these objections, which more directly concern the monetary authorities, it must not be forgotten that the enterprise sector's current account deposits stand at almost 20,000 billion, giving an average yield for 1974 estimated at 1,500 billion. Were this income to be wiped out, the enterprises would be deprived of considerable revenue, while any reduction in costs would not be evenly distributed because of the marked differences in the creditor and debtor positions of the various categories of enterprise and branches of activity. Nor can we disregard the possible impact on capital outflows when the provisions are introduced, as well as the encouragement to invest in shelter goods at a time of inflation.

It is possible that the banks' savings on demand deposits would not be passed onto the enterprises or that, depending on the lending rate supported by credit demand, they would go towards improving rates on time deposits, thus causing a change in the structure of bank rates to the detriment of bonds and a net overall loss for borrowers.

The reduction of interest on current accounts, or its abolition, could bring considerable advantages in terms of market shares to banks whose customers are mainly savers compared with banks whose business is primarily conducted with enterprises: the savings banks as opposed to the commercial banks. Finally, the introduction in Italy of a law prohibiting the payment of interest on demand deposits or merely discriminating against them must be regarded as a very radical change and one which would have wide repercussions on the structure of bank intermediation, on monetary policy and on enterprises' balance sheets.

Any approach towards regulation of interest payments on current accounts must be cautious and gradual; one of the preconditions is the creation of a money market to which the public has

access. The events of the past two years provide information on two different, but interrelated, aspects of regulation by the monetary authorities: the first is liquidity control and thus conditions of issue of Treasury bills and market intervention; the second concerns the issuing methods and workings of the secondary market. In order to control monetary base, the authorities must accept short-term interest rates that are consistent with the liquidity conditions they hope to achieve.

The measures recently introduced, following the Committee for Credit's decisions of March this year, are based on a variety of considerations. The auction system should allow the tender rate to be determined by the market. By admitting a wider range of dealers to the auctions we increase this rate's sensitivity to liquidity conditions in the economy. The Bank of Italy's participation is intended to strengthen competition in the market; regulation of Treasury bill rates should be sought through liquidity control. The need to ensure that Treasury bills have a sufficient degree of marketability must be met through a secondary market.

The creation of a money market should not be limited exclusively to public-sector securities; securities issued to finance the enterprises should also be included. There is already some indication that this is developing, and the authorities will not be backward in encouraging it. A growing money market would bring an element of competition which the banks would not be able to ignore.

Should the spread between lending and deposit rates exceed the limits necessary for intermediation under the stimulus of competition then some of this intermediation would shift out of the hands of the banks. Their oligopolistic position might thus be weakened.

The central bank would have greater scope for manoeuvre if the Treasury covered its cash requirements by tapping more of the public's assets. The Bank of Italy would then be able to increase its refinancing facilities for the banks and give preference to those that complied more strictly with the rules of a competitive market.

Available data reveal that, in comparison with other countries, the spread between average lending and deposit rates between 1971 and 1974 was somewhat wider in Italy, and that it tended to widen more at times when rates were rising; we have analyzed the structural causes of this phenomenon on previous occasions. On the other hand, the ratio of the volume of deposits to the number of branches and employees of the main Italian banks was generally higher than for

banks in other countries. One can deduce from this that our policy regarding authorizations to open new branches has had the desired results; the criteria employed in granting these authorizations are discussed at length in a report published by the Ente Einaudi.

The banking system gave proof of its strength last summer by coping without difficulty with withdrawals by non-residents amounting to some 5,000 billion: it was able to do so because it had prudently observed the principle of matching maturities. The only exception was the bankruptcy of the Banca Privata Italiana; here the authorities intervened as on previous occasions to ensure that the claims of depositors and other creditors were met. The terms and conditions of intervention were formalized by the Ministerial Decree of September 27, 1974. Similar regulations have recently been introduced in West Germany.

The policy always followed in Italy has been to help banks in difficulty, in some cases by encouraging the larger banks to intervene; compulsory liquidation has only been invoked when rescue attempts have failed to restore viability. Over the past five years, the Bank of Italy has made 633 general inspections of banks; 167 reports of irregular activities were made to the legal authorities; in 404 cases the administrative sanctions laid down in the banking law were applied.

The Capital Market and the Enterprises' Indebtedness

One of the sectors most affected by the shift in public preferences was the mortgage bond sector. It was in fact possible to pass on to holders of mortgage bonds some of the advantages accruing to house-owning debtors and we were in favour of such action, but this question should be solved by legislation.

When market conditions permitted, we introduced provisions to make the placement of mortgage bonds easier. However, paradoxically, some institutions are unable, at the moment, to issue enough bonds to satisfy the banks' compulsory investment requirements; the reason is that, primarily because of administrative difficulties, the institutions are unable to grant an equivalent amount of loans to house-building.

Hoping to add to the market's range of financial instruments and at the same time increase the supply of financing for house-building, we felt we must create instruments that would widen the choice open to savers and enable households with small savings, but a high propensity to save in the future, to purchase houses. The mechanism we evolved was called "savings-for-houses"; it is a modified version of schemes already tried in other countries and is intended to act as a cyclical stabilizer for the sector, alongside the mortgage bond market. The latter already plays an important role in financing building, one which has been officially recognized in provisions concerning both compulsory investment by the banks and the increase in nominal rates on these bonds.

Our proposal aims to use indexation of the deposits to increase the propensity to save of Italian households and Italian workers abroad. The mechanism guarantees that savers will be able to obtain a loan towards the purchase of a house: this loan will be equal to a multiple of the deposit; the minimum multiple is set by law and can be raised by ministerial decree. The burden of indexation of the deposits is paid by the borrowers who are, however, protected as regards this uncertain portion of their debt by the fact that the rise in percentage terms will not exceed their salary increases to cover the higher cost of living; in other words, the burden of debt will never take a larger portion out of the family budget. A system of guarantees becomes operative when unemployment or other unforeseen events reduce the debtor's salary.

The main objection to the scheme has been that it does not take into account political agreements over town planning, and on this basis the range of choices open to savers has been restricted. The restrictions in question are related to town-planning programmes, in other words, the structure of housing supply. Their inclusion in the "savings-for-houses" scheme, which remains a financial instrument, makes it more difficult to manage and more dependent on administrative regulations, and the saver has been denied the right to work out his own savings and investment plan. Consequently, our capital market can no longer expand as it would have done with the introduction of forms of savings investment that only experience would show to be consistent with savers' preferences or not.

Last year, we observed that the institutions and bodies that raise funds through bond issues were facing growing difficulties and we encouraged recourse to new methods of fund-raising; we came to the

conclusion that general indexing of securities issues would depress the prices of those in circulation. Indexation is effective when limited to well-defined sections of the market and when its introduction is optional; the "savings-for-houses" scheme incorporates both these features. There has been no progress towards solving the problem of financing enterprises other than through borrowing; over the years, we have often drawn attention to the fact that risk capital is decreasing.

In the Concluding Remarks to the 1967 Report, we stated that the large public and private enterprises receiving concessionary-rate credit should be obliged to offer part of their own shares for public subscription and ask for them to be listed on the stock exchange. This would not only increase investors' alternatives and involve a greater number of people in the activity of the enterprise but would lead to a more informed public. The reform of stock exchange regulations and the creation of a supervisory body will also help to achieve this aim. I have recently brought up this question again: given the sheer size of the enterprises' indebtedness, especially in the form of concessionary-rate credit, part of the loans should be converted into shares that the creditor institutions could offer directly to the public, place in trusts or possibly hold until final placement.

If the entire structure of our economy, and in particular of certain sectors, is to be critically reviewed, along with the organization of enterprises, then the economic planning agencies and the special credit institutions must co-operate. The lack of exchange between the two may be one of the reasons why many programmes have eventually turned out to be impracticable; the enterprises have concentrated on gaining official approval for their investment projects in the belief that there would be no lack of credit. In some instances, the tendency to give to one enterprise the same treatment that has been given to others has led to a careless disregard for the duplication of projects which destroys wealth.

Successful programmed action would moderate the conflict between public and private enterprises and encourage their coexistence; but if this aim is to be achieved the enterprises must not seek protection against their competitors by acquiring part of their capital. By keeping our economy open, we would protect competition from the possible formation of cartels.

Since the early 1960s the financial structure of Italian enterprises has undergone radical changes; a study of the balance sheets of the

manufacturing companies included in the Bank of Italy's survey shows this clearly. If we examine the net commercial debt/credit position along with non-liquid assets net of depreciations and group together the remaining liabilities, we obtain three broad headings of liabilities risk capital, pensions and insurance funds and indebtedness that clearly reveal the decline in the ratio of own resources to other funds. Between 1962 and 1973, the risk capital of the state-controlled enterprises fell from 44 to 19 per cent; their total indebtedness rose from 51 to 73 per cent, the whole of the increase being accounted for by liabilities vis-à-vis credit institutions, which rose from 37 to 62 per cent. It should be added that the risk capital of these enterprises is mainly made up of funds provided by state holding companies and is thus drawn from endowment funds that are financed by further indebtedness. The risk capital of private enterprises dropped from 56 to 33 per cent, while total indebtedness rose from 37 to 52 per cent. If the real capital and amortization funds are valued on the basis of replacement cost and risk capital is accorded the higher values, the latter would amount to 34 per cent in 1973 as opposed to 19 among the state-controlled enterprises and to 39 as opposed to 33 per cent in the private-company sector.

In view of these structural changes, which may remove responsibility from the debtor enterprises, the country must decide whether it still wishes to delegate management choices to public and private enterprise managers alone or whether it wishes to exert some control over the use of financial savings through institutional devices that have been adapted to the new circumstances.

As others have already pointed out, and as we ourselves said during the parliamentary survey on the stock exchanges, similar trends have been observed in many other industrial countries; but in a number of these steps have been taken to reform the institutional framework.

In our system, the main burden of risk falls on the capital market and in particular on that section of it which has no access to the management of the enterprises. In these circumstances, a change in the organization of the financial intermediaries would seem to be called for; the present system need not necessarily be substituted but it must certainly be modified. Limitations imposed by financiers in the exercise of their duties as administrators of savers' money could offset the constraints on public enterprise managers who must follow orders issued by the political authorities against arguments that the project is not economical.

New ways of enlarging risk capital must be studied and old methods improved; we must remove the existing incentive to borrow provided by the present system of government subsidies and instead make conditions more favourable for equity capital. We should also activate the institutional devices much talked about in the past, relating to the nature of shareholding and the methods of participating in the management of the firm. Finally, under present risk conditions, we should enlarge the banks' equity base by placing a large amount of shares with the public through issues' of the new "savings shares". This would not only reduce the ratio of the public's liquid assets to the increase in enterprises' frozen liabilities, but would also offset the corresponding increase in financial intermediaries' frozen assets.

If the aim of increasing enterprises' risk capital to at least the levels normal in other industrial countries were hampered by savers' preferences, then the need to give financial intermediaries a more active role in the management of enterprises in debt would have to be faced realistically.

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The course so far followed by monetary policy has once again been described as moderate, since it is not felt to be giving our economy sufficient stimulus to reach full employment income. Increased deficit spending and larger money creation are being called for, without taking into account the automatic mechanisms that expand the former and their repercussions on the latter, in the sure knowledge that this is the most effective and suitable method of closing the gap between actual and potential income.

The government sector has commitments totalling many thousands of billions; the local authorities are weighed down by debts that have soared over the years, while insisting on the need for operations to transfer all or some of their debts to the government; the government's debts to the health services have only partly been repaid: vast sums are still outstanding; the Treasury might be called upon to honour the guarantees granted to the motorways and electric power sectors.

These commitments can be met through issues of public-sector bonds and their compulsory placement with the banks to whom the

authorities are indebted in order to fund the credit in question; this is tantamount to admitting that the public sector is insolvent and to increasing the amount of bonds in circulation out of all proportion; despite restrictions on the circulation of securities, an increase in their volume would undoubtedly exert pressure on the market and on interest rates. On the other hand, part of the credit may be converted into cash, but in this case public-sector securities would have to be offered on the market in competition with those issued to finance the productive sectors. Alternatively, these public-sector securities could be placed with the Bank of Italy. In all events the local authorities would have scope for further borrowing. The government is under growing pressure to increase expenditure, the deficit and, consequently, the money supply. However, it is obvious that an expansion of the money supply and public expenditure in the forms that it has taken so far has little impact on the domestic product in real terms; the expansionary effect of the increase in monetary demand tends to be countered by the constraints of the balance of payments and inflation before it leads to any significant rise in employment. It is essential to avoid shortly having to make further and costly adjustments of non-consolidated increases in the employment level.

I have frequently stressed the difficulty of attaining the potential level of income by the traditional means of expanding demand and their more rapid side-effects on the balance of payments and on inflation, which have been ascribed to the numerous bottlenecks in the market of factors of production, to the abnormal growth of non-productive sectors and to the amount of credit absorbed by the latter. The situation has been aggravated by the sharp deterioration in the terms of trade.

We have recently attempted to use selective credit and fiscal intervention to improve the transmission of the effects of economic policy. Although results have been positive, the type of selective policy tried so far has not been capable of preventing the expansion of demand from having repercussions on the balance of payments and the level of prices. From the viewpoint of its cyclical effects, more specific intervention, by sectors such as that in favour of housing, agriculture, energy production and exports, is of limited application owing to structural bottlenecks. Certainly, increasing budgetary outlays and expanding credit is no way to remove those bottlenecks.

Within the present system, the old relationships between productive forces have been altered: awareness of this fact is a pre-

condition for eliminating social conflicts. The central power tends to gather within itself all the particles of power that are dispersed throughout the social body; it is the vitality of these particles that enabled us to overcome the difficulties forecast a year ago. This vitality must not be destroyed but must be directed towards adapting the economy's structure to the needs of a society that is calling for more justice, more participation and more democracy.

International co-operation has suffered because our voice has become weaker; there is no reason why we should not raise our voice in defence of national interests that are in harmony with those of a community of nations in which development is reconciled with peaceful co-existence.