Financial Assets, Public Debt and Monetary Policy: an International Integration Perspective *

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Introduction

1. - PREAMBLE

1.*a*. - In April 1986 the Minister of the Treasury decided to appoint a Committee of Enquiry to investigate financial wealth. The Decree establishing the Committee indicated a number of factors that appeared to have the greatest influence on the growth and composition of wealth: the trend in the budget deficit, interest rates, the degree of liberalization of cross-border capital flows, developments in the financial structure of enterprises and the diversification of households' financial assets. The Committee was instructed to analyse these factors with reference to "a range of hypotheses" regarding the growth in income, saving and prices over the next five years and to make proposals "for general guidelines and specific measures... to maintain balance between the growth of income and/or financial wealth and the growth in financial assets and appropriate relationships between the various types of instrument", as well as between sectors with financial surpluses and those with deficits, subject to the requirement "to safeguard the control capability of monetary policy".

At its very first meeting, the Committee judged its terms of reference to be too wide for the time available; it therefore resolved to limit and define its tasks within the framework of the mandate from the Minister.

1.*b*. - The first problem that arose in defining the Committee's mandate concerned the relative importance to be attached to description, analysis and proposals.

As far as description of the facts is concerned, we confined ourselves to highlighting the distinctive features of the Italian financial system and the way in which it is developing, so that the recipients of the Report would be able to make a direct comparison with the systems in other industrial countries.

The analytical and propositional aspects presented a problem that was common to both, namely whether the Committee could base its deliberations on a specific theory and on a particular model based on such a theory. The Committee chose not to follow this path. The results that can be obtained by using rigorously defined models depend crucially on highly specific hypotheses, particularly in the field under examination here; nor is it easy to differentiate between alternative

models on the basis of empirical verification because of the frequent lack of adequate data of sufficiently high quality and the ambiguity of the estimates. Nor did it seem advisable, in the report of a Ministerial Committee, to rely on simulations carried out using the econometric models currently available, firstly because different models often produce completely different results (including their sign) and secondly because the models are specified mainly from the demand side and relate to a comparatively short period, whereas many of the aggregates under consideration — and particularly those relating to public debt — can not only influence supply but also exert an effect over longer periods.

This does not imply that the Committee had no analytical frame of reference whatsoever; such a framework must always be present, explicitly or implicitly, if one wishes to produce more than just a description of little value. The Committee relied upon portfolio choice theory, which analytical experience shows to be sufficiently general and to yield fruitful results. This served as the frame of reference for both analysis and proposals, but the Committee did not use a specific version of the theory permitting precise verification and simulation.

1.*c.* - A further problem was encountered when the Committee came to draft proposals, namely whether to concentrate on certain fundamental disequilibria in the Italian situation or on measures that would make them easier to live with. The most important of the existing disequilibria stems from the situation and outlook regarding public finances and the public sector's growing debt. The Committee firmly agreed that this problem cannot be remedied by means of financial expedients; its origins lie in the real economy and, unless there is a change in trend, will sooner or later also have unavoidable repercussions on economic activity. However, this conclusion did not prevent the Committee from making specific proposals, albeit geared primarily towards the medium-term. Indeed, the coexistence of the above-mentioned trends in the public finances with a process of financial liberalization that must necessarily include Italy raises particular problems to which the Committee turned its attention.

1.*d.* - To clarify these points, it may be recalled that the problems the Committee had to tackle stem from a number of facts, trends, constraints and objectives.

The facts: the scale of the public debt in relation to both output and wealth; the persistence of disequilibria in the public finances; the use of monetary policy and especially direct controls over foreign exchange flows and, in the recent past, over credit to correct inconsistencies between the objectives.

The trends: the growth in debt and financial assets in relation to the growth in output or the stock of total wealth for some time to come, even assuming rigorous adjustment of the government budget; the internationalization of Italy's financial markets and industry, resulting in a trend towards the liberalization of capital movements, the deregulation and harmonization of services and types of intermediaries, and the creation of global markets; the diversification of households' portfolios to include assets denominated in currencies other than the lira and instruments other than government securities.

The constraints: medium-term balance-of-payments equilibrium; maintenance of the lira within the European Monetary System; the adjustment of structures and legislation to the requirements of the single European market.

The objectives: faster growth and more rapid capital formation in order to improve the prospects for employment; price stability and a stable financial system to foster efficient resource allocation and investment.

1.*e.* - The problems to be tackled stem from the contradictions that can and do arise between facts and trends and which manifest themselves in the difficulty of observing the constraints and/or attaining the desired objectives. An expansion in the public debt at a rate similar to that witnessed in the recent past tends to cause an excess supply of financial assets, jeopardizing price stability if the debt is monetized or endangering the growth in income and investment if it gradually squeezes out productive capital; nor can the external constraints of balance-of-payments equilibrium, exchange rate stability and European integration be respected unless the incompatibility between the expansion in the public debt and the final objectives is somehow resolved.

Other problems stem from the contrast between Italy's undeniable tradition of protectionism in the matter of foreign exchange, the internationalization of firms, production and finance and the external constraints, at least as regards the exchange rate. At a time when manufacturing firms are tending to acquire financial overtones, when the location of financial activities is coming to depend increasingly on

the freedom of capital movements and when households are seeking to safeguard the value of their wealth by diversifying, it is becoming ever more difficult to treat capital movements and trade transactions differently. However, spontaneous trends are moving in the same direction as developments within the Community. In addition to the existing obligations to liberalize, the EEC Commission is examining a draft Directive which should not only completely liberalize capital movements and payments but also establish the freedom to supply financial services throughout the single market.

The Committee considers that the trend towards foreign exchange liberalization is irreversible and that it would be neither feasible nor beneficial to oppose it. Nevertheless, there can be no doubt that it gives rise to not a few problems over the short- and medium-term.

The most important question concerns the manner and timing of liberalization. Another relates to the measures to be taken to ensure that restoration of the freedom to invest abroad does not have abrupt detrimental effects either on the balance-of-payments or on the scope for and cost of financing the budget deficit.

Other difficulties stem from the consideration that liberalization should not only improve the allocation of resources by firms and of saving by households but also foster the modernization of certain structures and financial services in Italy. If progress on this front does not keep pace with the dismantling of barriers to movements of capital, not only will the tendency to seek better investment opportunities abroad intensify but inflows of foreign capital may become less plentiful, not to mention the possibility that the Italian market will be an easy target for better prepared competitors from abroad as the liberalization of financial services finally becomes a reality.

Another important group of themes concerns monetary policy instruments and objectives in the conditions prevailing in Italy, namely the existence of a highly complex financial superstructure, persistently high budget deficits and continual growth in the public debt in relation to both output and wealth, as well as an external constraint. In such a situation, the liberalization of exchange controls creates new problems for monetary policy; not only does it limit the room for manoeuvre, but it will combine with the reduction of protectionism in financial services to promote financial innovation, which so far has been less vigorous in Italy than elsewhere.

Where financial innovation has progressed further, it has lessened the significance and usefulness of certain indicators such as the

monetary and credit aggregates, blurred the distinction between short-term lending and credit at medium- and long-term, vitiated monetary policy based on controlling the availability of credit by creating alternatives, shifted the emphasis to interest rates — which will cease to be controlled by any single central bank once capital movements have been completely liberalized — and thus given increasing weight to the exchange rate as an objective and channel of monetary policy.

Finally, in connection with monetary policy issues, there are complex problems in the management of the public debt. In the context of liberalization, these stem from at least three types of requirement: harmonization with monetary policy, investors' preferences and minimization of the cost of debt to the Treasury.

1.*f.* - The tax regime is certainly one issue of great importance for the structure and development of financial wealth. This aspect was not examined by the Committee, though it had a bearing on its deliberations. An investigation of the taxation of financial assets would not be complete without examining the objectives of taxation and the general principles underlying the structure and level of taxation in general, considering the burden of taxation on real assets in relation to that on financial assets and reflecting upon the slowness of the Community's harmonization of taxes on interest, dividends and securities transactions at a time of more rapid liberalization. The Committee was unable to undertake such a wide-ranging examination, which would have gone beyond its terms of reference. Accordingly, it confined itself to making certain specific proposals, which nevertheless strictly respected the revenue constraint and the objective of fiscal neutrality both at the national level in regard to income of the same nature and internationally between different markets.

2. - Summary and conclusions

The six sections of this Report are devoted to the examination of the problems indicated above, or at least to some aspects of them. In what follows, we shall describe their content and list the main proposals derived from our analysis.

2.*a.* - Section 1 contains a summary of the information available on the development and composition of the wealth of Italian house-

holds. The ratio of total wealth to income is in line with those found for other countries, while there are differences in both the composition and the changes of wealth over the period in question.

2.*b*. - The analytical framework to which the Committee made reference is described in Section 2. As mentioned above, the study of financial assets was carried out on the basis of portfolio theory, which is especially suitable when financial innovation and exchange liberalization have to be taken into account. The factors giving rise to the formation of saving and the accumulation of wealth are examined as well as economic agents' choices among the various financial instruments available. The approach clearly reveals the risks associated with continuous growth of the public debt and its absorption of a growing share of wealth. The dangers may involve either financial and monetary stability or the crowding out of real capital formation, and hence of growth and employment. The first priority, therefore, is for determined action to put public finances on a sound footing, so that the rising trend of the ratio of the public debt to GDP is halted and reversed in just a few years. Guidelines for progress in this direction were established in the plan presented to Parliament in June 1986. The need for rehabilitation is made all the more urgent by the prospect of exchange liberalization that will reduce the room for manoeuvre the Treasury has enjoyed to date in its financing of the budget deficit.

2.*c*. - The question of the liberalization of capital movements was one of those on which the Committee focused the most attention, in view of its awareness not only of the external constraint but also of an exchange rate mechanism that has more than a purely economic and political significance and reflects the ideals of European economic and monetary union. In all likelihood, therefore, exchange and interest rate policy are bound to be influenced by the liberalization of capital movements, while allowing households greater freedom to invest abroad may well have a once-and-for-all effect on the reserves. Should it prove necessary, this could be offset by the public sector undertaking operations in the opposite direction. In addition to explaining the reasons why it appears desirable to continue with and speed up Italy's financial integration, Section 3 examines the links between the exchange liberalization of national economies and their financial and monetary integration. It also makes recommendations on the form that the delegated legislation shortly to be enacted should take and on how

the liberalization process should proceed. In particular, the Committee recommends a set of coordinated measures leading to the internationalization of the lira by: removing, one by one, the constraints on its participation in international transactions; granting firms greater freedom in the management of their foreign currency balances; and giving full and rapid effect to the agreements reached in the ECC on capital movements.

The Committee favours a gradual liberalization, but sets out the reasons why it believes the process both can and should be reasonably fast. It opts for: keeping the banking system as the channel for foreign exchange operations, introducing foreign currency "service" accounts until bank deposits themselves have been liberalized to make for smooth management of portfolios which include foreign assets; and ensuring that there is no discrimination in the fiscal treatment of domestic and foreign securities once exchange controls have been completely eliminated.

The process of liberalization needs to be flanked by a series of supporting measures. Apart from the rehabilitation of the public finances, which remains a basic precondition of lasting financial integration, these measures will have to promote: improvements in the management of the public debt; maintenance of the wider fluctuation band for the lira in the EMS until the process has been completed; and an appropriate policy for interventions in the forward exchange market. On the other hand, the Committee comes out against recourse to safeguard mechanisms such as quantity restrictions and non-interest-bearing deposits, and foresees practical difficulties in trying to administer a two-tier foreign exchange market.

Other measures to accompany liberalization will have to be negotiated in the Community. The Committee believes that it will be especially important to reorganize the EEC's financial instruments to permit their use in the event of capital outflows produced by the transition to freedom of capital movements and, above all, to arrive at an adequate definition of EEC economic and monetary policy. The latter condition is necessary if the countries removing their exchange controls and thereby increasing their integration are to have a greater knowledge of and influence on the macroeconomic model used for the management of the Community as a whole.

2.*d*. - One of the aspects of financial intermediation that the Committee deemed to merit special attention was the stock exchange.

Since this is a field that has already been studied by other bodies, the Committee only focused in detail on the aspects with the greatest bearing on the key themes of the Report. Despite the recent growth of this market, especially in terms of share prices, it is still narrowly based in terms of listed securities.

Section 4 analyses the reasons for the lack of corporate interest in seeking a stock exchange listing and identifies a series of costs for companies, their governing organs and shareholders in terms of the information that has to be supplied. Insofar as the transparency of the market will require this to be increased rather than decreased, the incentive to seek a listing normally lies in fiscal advantages. Since the Committee disapproved of such privileges and believed that it would be appropriate to eliminate the existing disparities of treatment, it explored the scope offered by existing Italian law for listed shares to circulate in the form of bearer instruments. The Committee concluded that such an innovation would be both feasible and desirable in civil law and fiscal terms. Some doubts remained regarding the technique to be adopted for controls, though they could be cleared by recourse to other instruments.

Another aspect the Committee examined was the working of the share market, focusing on: the identification of listing requirements, with the aim of excluding captive companies; the circulation of physical certificates, which is certainly to be discouraged but without this leading to a legal monopoly of custody; and the advisability of requiring investment funds to channel all or a part of the resources they theoretically could invest in unlisted securities through the over-the-counter market, which in any case should be developed as a local market.

2.*e*. - Monetary policy also finds itself boxed in on three sides by: innovation, which modifies the parameters of its objective function; the growing size of the public debt, insofar as it is necessarily concerned with the latter's absorption into savers' and intermediaries' portfolios; and the alteration produced by the process of liberalization in the behaviour of firms and households, with the consequent change in the nature of the external constraint.

The present "modus operandi" of monetary policy is investigated in Section 5. It is based on a target growth rate for money (M2) and the domestic credit disbursed to the non-state sector and employs instruments such as control of the monetary base and, in operational terms, of

banks' free reserves. Interest rates stand out as the basic channel for transmitting monetary policy.

Innovation and the liberalization of capital movements will increasingly change some of the cornerstones of monetary policy's operational model: the definition of money; its creation; the demand for money; and the transmission mechanism. At the same time, the problems associated with the public debt will remain serious, regardless of the recently announced revision of the national accounts.

With the aim of creating an environment better suited to the future "modus operandi" of monetary policy, the Committee suggested that the emphasis should be shifted from the primary to the secondary market for securities since this would not only make it possible to influence the structure of interest rates directly but would also make it easier to draw conclusions regarding the conditions of new issues, preferably to be made by auction.

In relation to the monetary policy approach in force today, the Committee considered that there was a need to reduce the transmission lag of monetary policy impulses and increase their effect on banks' balance sheets.

Specifically, with reference to banks' liabilities, the Committee considered it would be desirable for deposit interest to be credited more frequently and for the role of certificates of deposit to be expanded, in part through the introduction of such instruments denominated in ECUs. On the assets side, the charging of a committment fee on credit facilities is proposed. As for the interbank market, the Report stresses the need for greater efficiency and flexibility, goals that appear to require a revision of the tax treatment of the related operations. For the special credit institutions, the Report also draws attention to the need for changes in the tax on medium- and long-term loans.

On the working of the capital markets, the Committee believed it was necessary to aim at a primary market for government securities that would be able to absorb issues without direct support from the central bank, by recreating an adequate differential between auction floor prices and those ruling in the market and by facilitating the activity of the intermediaries specialized in this market.

2.*f*. - Finally, in view of the present and prospective importance of the public debt, Section 6 examines the problems associated with the state sector borrowing requirement and the strategy for the management of the debt, with reference both to operators' preferences for the

various types of security and to the cost to the Treasury of issuing them. Good management of the debt at a time of falling inflation would shift its composition towards fixed rate securities and restore investors' preferred habitats. This can be used to ensure a lower cost for the Treasury.

Among the proposals put forward by the Committee it is worth mentioning the introduction of a short-term security denominated in ECUs (designed to meet the demand for diversification in the short term) and the issue of price-indexed securities. Both these instruments, together with a lengthening of the maturities of those already adopted, would broaden subscribers' choice and reduce the burden on the Treasury.

Section 1. - The saving, investment, financial assets and wealth of the private sector: a survey of facts and figures

1.1. - Introduction

The separation between decisions regarding saving on the one hand and the accumulation of capital on the other, the large scale of public sector intervention in the economy and the high degree of integration in both the real and the financial sectors are basic features of modern industrial economies. They contribute to the need for a highly developed financial system permitting the efficient transfer of resources from operators in surplus, whose saving exceeds their direct investment in real assets, to those in deficit. For the purpose of formulating economic policy, it is important both to know the total amount of financial wealth and its sectoral distribution and to link its development to that of the real variables that help to determine its formation.

To conduct such an analysis, recourse inevitably has to be made to the information provided by the national and the flow-of-funds accounts. The former enable the net surplus or deficit of each sector to be determined as the difference between saving and investment, while the latter serve to identify the instruments used to raise the necessary funds and invest excess saving.

It is also useful when analyzing financial assets in Italy to compare their development with that of the other leading European countries. This section will provide a summary survey of these aspects.

1.2. - Saving, investment and financial flows

The net surplus or deficit of each sector is estimated in the national accounts as the difference between saving and investment, excluding net transfers on capital account. The national accounts do not indicate, however, where the deficit sectors obtain the funds they need, nor what financial assets the surplus sectors acquire. Furthermore, a sector may simultaneously increase its debt and its holdings of financial assets.

The flow-of-funds accounts fill this gap by providing a conceptual framework for the regular collection and publication of statistics on financial flows, though the balance obtained in this way rarely coincides with the sectoral surplus or deficit of the national accounts. This is

especially true for the non-financial domestic sectors — households, enterprises and the public sector. The main causes of this discrepancy in Italy are: the different definitions of the various sectors with respect to partnerships, financial firms and the autonomous government agencies; the different valuations of investment in buildings; and disparities in the treatment of the technical reserves of social security institutions.

The development of investment and saving, the two variables that principally determine sectoral balances, are examined below for the period 1960-85 (Table 1.1).

The saving rate of the economy as a whole tended to decrease in relation to GDP, and recorded an especially sharp fall after 1981. The main determinant of this downward trend was the current account balance of general government, which swung from a surplus equivalent to 2.8 per cent of GDP on average between 1960 and 1964 to a deficit that rose to 7.4 per cent of GDP in 1984-85. The growth in the saving of the other sectors, and especially of households, was not fast enough to offset the expansion of the public sector deficit.

When assessing changes in the saving rate, it is necessary to bear in mind that the interpretation of the behaviour of economic agents in periods of high inflation is distorted if the traditional definitions of saving and financial balances are used. These definitions fail to take account of the purchasing power gains and losses that arise for the net holders of respectively liabilities and financial assets the principal of which is not price-indexed. Such gains and losses are likely to affect the saving rate because economic agents tend to offset their effects on net financial wealth with the aim of keeping this at the desired level. Failure to consider these gains and losses results in an overestimate of the income of the surplus sectors and an underestimate of that of the deficit sectors.

The downward trend of the aggregate saving rate (in which the sectoral distortions generated by inflation tend to cancel out) is reflected both in the external account (with large current account deficits being recorded in many years, leading to a negative net external position, Table 1.2) and in the accumulation of capital. Gross fixed capital formation at constant prices fell in relation to GDP from 25 per cent in 1960-64 to 18.3 per cent in 1975-79 and to 17.5 per cent in 1985 (Table 1.1). This decrease may also reflect the structural and technological changes that occurred in the process of accumulation, in particular the reduction in capital intensive investment.

TABLE 1.1

INVESTMENT AND SAVING
(percentage ratios to GDP)[1]

	Constant prices	Current prices								
		Gross fixed capital formation					Gross saving			
	Gross capital formation	Private sector		General government	Change in stocks	External current account balance	Total	Private sector		General government
		Dwellings	Others						of which: households	
1960-64	25.0	6.2	13.6	3.3	1.5	0.4	25.0	22.2	16.7	2.8
1965-69	21.5	6.0	11.0	2.9	0.6	3.0	23.5	23.0	16.7	0.5
1970-74	22.1	5.7	12.3	3.1	2.4	−0,9	22.6	25.0	19.7	−2.4
1975-79	18.3	5.1	11.0	3.3	1.9	0.7	22.0	27.2	22.3	−5.2
1980	21.2	5.3	11.1	3.4	5.2	−2.5	22.5	26.3	19.9	−3.8
1981	18.2	5.5	10.9	3.8	1.1	−2.3	19.0	25.0	20.4	−6.8
1982	17.4	5.3	9.7	4.0	1.1	−1.6	18.5	25.7	20.1	−7.2
1983	16.1	5.1	8.7	4.2	−0.2	0.2	17.9	24.1	19.3	−6.2
1984	17.2	4.9	9.2	4.1	0.8	−0.8	18.1	25.5	20.4	−7.4
1985	17.5	4.7	9.6	3.9	0.7	−1.2	17.7	25.1	20.3	−7.4

[1] The data for the sixties, except for those on dwellings, are those recalculated by ISTAT on the basis of the revised national accounts. The data for dwellings, which have not yet been recalculated, are those of the old national accounts series.

Source: ISTAT, *Annuario di contabilità nazionale*; the 1983-85 figures for households' saving are estimates based on ISTAT and Bank of Italy data.

TABLE 1.2

ITALY'S EXTERNAL BALANCE SHEET
(amounts in billions of dollars)

	ASSETS							LIABILITIES							NET POSITION	
	Investment		Loans	Trade credit	Bank lending	Official assets	Total	Investment		Loans	Trade debt	Bank borrowing	Official liabilities	Total		
	Direct (1)	Portfolio and other						Direct	Portfolio and other							Net financial position
1976	3.4	3.5	2.7	17.0	12.9	4.1	43.6	5.7	2.3	13.8	8.3	16.9	7.5	54.5	–10.9	– 9.8
1977	4.1	3.7	2.6	17.9	15.4	9.3	53.0	6.9	2.2	14.1	8.0	23.5	6.9	61.6	– 8.6	– 7.3
1978	4.8	5.1	3.0	22.4	23.2	12.6	71.1	8.0	2.8	16.6	10.3	30.3	3.3	71.3	– 0.2	0.7
1979	5.9	5.0	3.4	28.6	30.1	19.9	92.9	9.1	4.3	17.6	12.5	38.7	2.0	84.2	8.7	11.2
1980	7.0	5.5	4.1	26.8	31.4	24.6	99.4	8.9	6.0	23.6	12.5	47.3	2.2	100.5	– 1.1	1.3
1981	7.4	4.5	4.1	23.3	37.3	21.3	97.9	7.7	5.4	33.2	13.6	50.7	2.0	112.6	–14.7	–13.5
1982	8.1	4.4	4.5	21.2	35.1	15.0	88.3	7.4	4.7	39.1	11.0	45.7	1.3	109.2	–20.9	–21.3
1983	9.8	3.9	4.7	20.7	35.9	20.9	95.9	7.3	4.4	40.5	11.8	48.8	1.2	114.0	–18.1	–20.1
1984	11.9	4.6	5.4	19.1	37.6	21.5	100.1	9.3	4.8	40.6	11.9	52.7	0.8	120.1	–20.0	–22.4
1985	17.1	7.4	7.2	23.4	48.4	16.3	119.8	18.9	4.8	48.5	14.7	63.0	0.9	150.8	–31.0	–31.8

(1) Starting in 1983 the series includes public sector investment. The situation at end-1984 was affected by corrections and adjustments, especially in respect of the balance sheet value of interests in foreign holding companies.
(2) Net of the gold reserves.

Source: BANCA D'ITALIA, *Relazione Annuale per il 1985*.

The growing gap between the balance of the deficit sectors and that of the surplus sectors resulted in an increase in gross flows. After 1972 total domestic credit which records the flow of domestic funds to the various sectors of the domestic economy, with the major exception of share issues, remained close to or above 20 per cent in relation to GDP (Table 1.3).

The rapid expansion of the financial assets created as the counterpart of the flows of domestic credit ended up by raising the ratio of the private sector's financial assets to GDP. This ratio is also influenced by the rate of inflation, as mentioned earlier, and the real yield on financial assets. The latter was negative until 1982, while the rate of increase in property prices (a factor of special importance in households' investment decisions since it approximates the medium-term expectations of capital gains on this component of wealth) exceeded that of consumer prices in the same period. The combined effect of these two factors contributed to the fall in the ratio of the private sector's domestic financial assets (net of shares and severance pay provisions) to GDP from 127 per cent in 1973 to 113 per cent in 1979. The subsequent slowdown in inflation, which was especially marked for property prices, coupled with the increase in the real yields on financial assets and no reduction in the overall demand for credit, pushed up the ratio to 136 per cent at the end of 1985 and it has risen further in 1986.

An increase in the ratio of financial assets to GDP can be accompanied by a similar increase in that of liabilities, so that the ratio of net financial wealth to GDP remains virtually unchanged. However, on average the liabilities net of shares of the private sector rose more slowly or no faster than GDP, so that not only did the ratio of gross financial assets rise but so did that of net financial assets.

The gap between the growth in financial aggregates and that in nominal GDP did not widen only in Italy. The ratio of the private sector's financial assets (for the sake of comparability inclusive of shares, foreign assets and severance pay and pension provisions) to GDP also rose in Germany, the UK and France between 1975 and 1985 (1984 for France) by respectively 38.5, 28.6 and 7.8 per cent (Table 1.4).

This international comparison also shows that there is no significant correlation between this ratio and the inflation rate, which confirms that in periods of high inflation the nominal saving of the private sector includes an additional component designed to offset the resulting loss of purchasing power of financial wealth. Both Italy, which

TABLE 1.3

FINANCIAL FLOWS

	GDP		Total domestic state sector borrowing requirement (A)	Credit to the non-state sector (B) flows		Total domestic credit (A+B) flows			Private sector financial assets[1] flows			Private sector financial assets[1] end-year stocks	
	bn.	% var.	bn.	bn.	% var.	bn.	% var.	% GDP	bn.	% var.	% GDP	bn.	% GDP
1970	62,885	12.5	3,232	3,031	5,237	12.2	8,268	14.0	13.1	7,086	11.3	11.3	70,308	111.8
1971	68,510	8.9	4,843	4,293	7,657	15.9	11,950	18.1	17.4	11,189	15.9	16.3	81,855	119.5
1972	75,124	9.7	5,890	5,744	9,875	17.8	15,518	20.3	20.7	16,741	20.4	22.3	98,746	116.0
1973	89,746	19.5	8,013	7,242	13,877	21.3	21,119	23.3	23.5	17,125	17.3	19.1	114,152	127.2
1974	110,719	23.4	8,980	8,776	11,194	14.4	19,970	17.2	18.0	14,369	12.6	13.0	128,423	116.0
1975	125,378	13.2	16,444	14,218	16,814	18.6	31,031	22.5	24.8	26,554	20.7	21.2	151,607	120.9
1976	156,657	24.9	14,867	14,208	19,752	18.7	33,960	20.1	21.7	31,010	20.5	19.8	182,576	116.5
1977	190,083	21.3	22,567	17,973	17,281	13.8	35,254	17.4	18.5	35,782	19.6	18.8	218,482	114.9
1978	222,254	16.9	34,305	31,763	17,495	12.7	49,258	20.7	22.2	49,150	22.5	22.1	267,983	120.6
1979	270,198	21.6	30,403	28,562	25,261	16.5	53,823	18.7	19.9	58,075	21.7	21.5	326,864	121.0
1980	338,743	25.4	37,018	34,015	29,219	16.4	63,235	18.5	18.7	53,764	16.4	15.9	381,416	112.6
1981[2]	401,579	18.6	53,293	45,239	28,098	13.5	73,336	18.1	18.3	75,636	19.8	18.8	457,594	113.9
1982[2]	470,484	17.2	72,702	69,036	31,604	13.4	100,640	20.9	21.4	88,282	19.3	18.8	546,692	116.2
1983	539,844	14.7	88,257	85,194	35,432	13.2	120,626	20.7	22.3	109,238	20.0	20.2	656,811	121.7
1984[3]	615,119	13.9	95,387	91,400	48,322	15.6	139,723	19.7	22.7	130,913	19.9	21.3	788,414	128.2
1985[4]	684,843	11.3	110,226	107,109	37,000	10.3	144,000	16.9	21.0	136,751	17.3	20.0	930,912	135.9

[1] Domestic financial assets net of shares and severance pay and pension provisions.
[2] Credit to the non-state sector and total domestic credit are adjusted for the bank lending used to finance the non-interest-bearing deposit on payments abroad.
[3] Credit to the non-state sector and total domestic credit are adjusted for the distortions connected with the abolishment of the ceiling on bank lending.
[4] Credit to the non-state sector and total domestic credit are adjusted for the anomalous expansion in bank lending in lire in November and December 1985.

TABLE 1.4

THE FINANCIAL ASSETS AND LIABILITIES OF THE PRIVATE SECTOR IN THE LEADING EUROPEAN COUNTRIES

(end-year amounts as a percentage of GDP)

	ITALY			FRANCE			GERMANY			UNITED KINGDOM		
	Households	Firms	Private sector	Households	Firms	Private sector	Households	Firms	Private sector	Households	Firms	Private sector
						Financial Assets						
1975	114.7	46.9	161.6	93.6	22.6	116.2	91.5	40.9	132.4	130.8	62.4	193.2
1976	109.2	46.0	155.2	93.4	22.4	115.8	93.1	41.9	134.9	120.9	64.4	185.3
1977	104.9	43.6	148.5	94.4	22.2	116.6	96.6	43.6	140.1	131.2	63.2	194.4
1978	108.0	46.3	154.3	94.6	22.5	117.1	98.0	45.0	143.0	126.4	63.2	189.6
1979	106.5	49.7	156.2	94.4	22.7	117.1	98.2	43.5	141.7	124.7	61.5	186.2
1980	104.8	62.9	167.7	94.4	22.4	116.9	100.1	42.0	142.1	128.0	57.4	185.4
1981	105.4	65.9	171.4	94.9	22.7	117.5	104.4	46.7	151.1	130.0	61.3	191.3
1982	105.8	57.3	163.1	93.4	22.7	116.1	109.5	49.5	159.0	145.6	64.4	210.0
1983	111.7	59.7	171.4	102.1	23.7	125.8	112.1	53.5	165.6	157.6	68.9	226.5
1984	119.0	65.9	184.8	100.1	25.2	125.3	115.2	56.4	171.6	174.0	77.3	251.3
1985	131.7	96.3	228.1	. . .	. . .	. . .	119.6	63.8	183.4	180.2	68.3	248.5
						Liabilities						
1975	9.7	111.2	120.9	27.6	76.2	103.8	42.5	89.1	131.6	38.8	127.0	165.8
1976	8.4	100.0	108.4	28.3	74.3	102.6	42.6	86.1	128.7	37.8	120.8	158.6
1977	7.8	92.3	100.1	29.0	74.4	103.4	44.2	86.9	131.1	37.8	126.4	164.2
1978	7.6	92.6	100.2	29.5	71.8	101.3	46.3	85.4	131.7	38.5	119.5	158.0
1979	7.4	94.2	101.6	31.2	69.9	101.1	48.4	82.9	131.3	40.0	115.2	155.0
1980	7.3	107.8	115.1	32.2	69.0	101.2	50.5	82.7	133.2	39.3	111.4	150.7
1981	7.1	111.2	118.3	32.7	69.3	102.0	52.1	87.1	139.2	42.0	110.6	152.6
1982	7.1	100.9	108.0	33.4	68.9	102.3	53.8	89.9	143.7	45.7	118.3	164.0
1983	7.0	103.3	110.3	33.5	70.6	104.6	55.8	93.5	149.3	49.9	126.0	175.9
1984	7.1	111.4	118.5	33.7	71.6	105.3	56.8	97.6	154.4	54.7	140.1	194.8
1985	7.6	148.6	156.2	. . .	. . .	. . .	57.1	107.9	165.0	58.2	129.1	187.3

had one of the highest inflation rates in Europe, and Germany, which had one of the lowest, recorded similar rates of increase in their ratios of financial assets to GDP — respectively 41.2 and 38.5 per cent. Nonetheless the end-1985 figure for Italy (228 per cent) was considerably higher than that for Germany (183.4 per cent), though this was partly due to the sharp rise in share prices over the year and to the inclusion in the private sector of financial enterprises, which hold a large proportion of shares. The factors underlying the accumulation of financial assets in the two countries were also different — in Italy it served to finance the huge needs of the public sector and the deficit of the corporate sector, while in Germany it was the counterpart of large external current account surpluses.

When assessing the changes in the private sector's financial assets, it is useful to consider households and enterprises separately. As mentioned earlier, the separation between saving and investment decisions typical of modern industrial societies, together with the resulting high level of financial intermediation, results in a clear distinction between the decision-making processes by means of which these two categories of economic agents determine their (positive or negative) financial requirements and the allocation of the latter among the various instruments supplied by the market.

In the final analysis, firms' financial decisions always influence the net real financial wealth of households, the only sector in Italy for which it is possible to draw up a balance sheet, albeit incomplete. Accordingly, the financial assets and liabilities of the corporate and household sectors will be briefly described and the changes in them linked to the real variables that help to determine them.

1.3. - The corporate sector

1.3.1. - *The corporate sector in Italy*

Enterprises' investment normally exceeds their saving, so that the sector records deficits that have to be financed by external funds. This dependence on external sources of finance, and in particular on those more under the control of the monetary authorities, has meant that firms have played a key role in transmitting monetary policy impulses

to the final objectives. In the last few years the shift in the balance of the various sources of finance, the reorganization of production and the accumulation of easily realizable financial assets have combined with financial innovation to weaken the link between the availability of credit and firms' growth.

The period from 1950 to 1970 saw the highest average annual rate of real growth (about 6 per cent) ever sustained for so long. This result, to which a multiplicity of factors contributed, was accompanied by a considerable increase in financial intermediation since firms' investment expenditure was not covered entirely by their self-financing, even though this ran at a high level.

From the end of the sixties to the mid-seventies the incentive schemes for the economically backward regions, coupled with low interest rates, enabled industrial firms, especially the state-controlled companies and those operating in basic industries, to intensify their investment activity. Between 1969 and 1974 gross fixed capital formation in the corporate sector proceeded at an average annual rate of 6.4 per cent. In the same period the share of industrial value added in GDP rose to a peak of 43 per cent.

Another effect of this buildup of investment was to widen the gap between investment and internally generated funds. To make good the shortfall, firms made large-scale recourse to short- as well as medium- and long-term borrowing from the credit system (Table 1.5). In the period 1970-75 the ratio of firms' new financial liabilities to their total investment averaged 62 per cent.

The deterioration in the world economy and the huge changes that occurred in the relative prices of both factors of production and products precipitated situations that were already unbalanced.

Detailed analysis of firms' balance sheets is far from easy because of the difficulty of adjusting the values of individual items for inflation. Nonetheless, the various studies made all point to a rapid rise of their leverage in the first half of the seventies.

The flow-of-funds accounts show that in 1970 borrowing from the credit system accounted for 57 per cent of total corporate financing, while by 1976 this figure had risen to 73 per cent. The national accounts indicate the proportion of investment covered by self-financing to have fallen from 119 to 90 per cent over the same period. Data compiled by Mediobanca, based on the accounts of a group of mainly large and medium-sized companies, show that debt accounted for 49 per cent of total corporate liabilities at the beginning of the seventies and that this

TABLE 1.5

THE FINANCIAL ASSETS AND LIABILITIES OF FIRMS[1]
(flows in billions of lire)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Assets																
M2	1,657	2,445	5,942	3,548	695	7,048	6,859	8,241	11,636	14,784	6,995	10,988	15,358	13,207	15,761	11,354
Treasury bills	—	—	—	—	—	20	233	348	368	814	1,557	2,400	1,276	1,663	1,734	1,273
M3	1,657	2,445	5,942	3,548	695	7,068	7,092	8,589	12,004	15,598	8,664	13,459	16,606	14,804	17,449	12,609
Medium- and long-term securities	3	15	45	37	–48	–84	–171	1	384	258	–197	276	1,514	4,534	6,175	7,398
Domestic equity investment	346	394	578	1,269	437	568	306	–65	391	543	1,382	541	1,173	893	1,709	–2,855
Foreign assets[2]	461	513	1,418	544	118	523	–2,057	1,180	518	3,655	438	136	2,739	3,571	5,850	2,845
Other assets	36	73	78	682	845	–1,121	5,900	–5,363	168	237	233	4,263	–3,292	513	694	859
Total	2,503	3,440	8,061	6,080	2,047	6,954	11,070	4,108	13,465	20,291	10,520	18,675	18,739	24,315	31,877	20,856
Liabilities																
Short-term debt	2,275	1,869	3,278	4,608	9,609	4,840	10,254	8,636	8,294	15,669	16,357	11,217	12,965	18,974	28,522	29,944
Long-term debt	2,132	3,568	3,199	5,551	2,038	5,809	5,046	4,552	7,655	8,687	12,806	20,964	11,800	9,933	8,851	11,614
Bonds	44	509	757	797	96	1,376	955	1,236	974	482	193	820	4,589	2,392	1,906	1,844
Equity instruments	1,131	1,446	1,773	2,430	1,396	2,390	2,412	2,719	4,392	2,531	5,201	6,008	10,488	13,299	12,617	11,123
Other liabilities	959	908	1,182	1,207	1,675	2,039	2,453	1,708	1,751	2,551	4,087	6,023	631	3,425	3,624	4,492
Total	6,541	8,300	10,189	14,593	14,814	16,454	21,120	18,851	23,066	29,920	38,644	45,032	40,473	48,023	55,520	59,017
Financial balance	–4,038	–4,860	–2,128	–8,513	–12,767	–9,500	10,050	–14,743	–9,601	–9,629	–28,124	–26,357	–21,734	–23,708	–23,643	–38,161
Memorandum items:																
Bank lending	2,480	2,615	3,958	5,402	10,682	4,967	10,989	9,350	9,065	16,958	17,406	10,994	11,537	20,377	27,254	29,491
Special credit institution lending	1,249	2,443	2,277	3,849	2,727	4,532	4,334	4,250	5,707	5,326	7,633	12,313	10,414	7,212	10,285	9,277
Total investment	12,290	12,061	12,702	18,782	25,489	20,562	31,169	33,683	36,780	48,270	71,987	68,941	73,794	71,459	89,593	100,693

[1] The statistical series were compiled homogeneously as of 1976. For the earlier years the data were based on the Annual Reports of the Bank of Italy, except for those in respect of severance pay and pension provisions included in Other liabilities.
[2] Foreign assets include short-term trade credits net of the corresponding liabilities item.

figure rose to 55 per cent in 1976, with the share due to credit institutions rising from 22 to 26 per cent (Table 1.6).

The management of corporate finances is not concerned only with the relative importance of the various sources but also with the margin between the return on investment and the cost of capital. The problem, therefore, did not so much lie in the level of corporate debt as in the function debt financing was called upon to play. The deterioration in Italian firms' financial situation was due to the fall in the return on investment; borrowing took place to cover structural imbalances between costs and revenues rather than to bridge the delays, sometimes extremely long, between the acquisition of inputs and the sale of output.

It was not fully appreciated to what extent the corporate sector had clay feet until the mid-seventies, since real interest rates were low when they were not actually negative and credit subsidies were being applied on an increasingly wide scale. These conditions reduced firms' debt in real terms and implied transfers of income via the budget. It was nonetheless unsustainable for the economy as a whole for negative real interest rates to persist since they preclude correct allocation of resources.

Nominal interest rates rose after the first oil crisis, but less than prices, so that real interest rates fell still further. This accentuated the early repayment of principal on fixed rate debt — which accounted for the greater part, especially at medium- and long-term — and consequently improved firms' balance sheet structure. The fact that the reduction in the market value of corporate debt was not reflected in a rise in share prices was primarily due to the parallel deterioration in firms' profitability. Operating profits had come down owing to firms' inability either to raise prices in line with their costs or to absorb them by increasing the scale of their production.

Confirmation of the view that the decrease in firms' profitability was primarily due to the inadequacy of operating profits, and hence to real factors, is to be found in the fact that in 1974 the already low level of such profits in relation to capital invested (3 per cent) fell further in the following years and was only to return to that level ten years later.

The information obtainable from company accounts may not correspond altogether to reality, insofar as the inflation of the last ten years may have reduced the significance of accounts prepared under the historical cost convention. To overcome this shortcoming, various methods of adjusting company accounts have been proposed, based, either on the general level of prices (CPP - current purchasing power)

TABLE 1.6

BALANCE SHEET DATA AND INDICATORS OF PROFITABILITY FOR A GROUP OF ITALIAN FIRMS
(percentages)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Gross tangible fixed assets	60.7	61.4	61.7	58.9	54.7	56.0	53.2	51.0	48.9	46.0	43.5	40.3	42.2	45.2	44.2	44.7
Stocks	14.0	13.8	12.8	12.9	16.9	16.8	17.1	18.5	18.3	19.2	20.7	19.7	18.1	15.9	15.6	15.4
Financial assets[1]	5.6	5.2	5.8	6.5	5.5	4.8	5.5	5.7	6.6	7.0	7.5	8.4	9.0	9.2	11.1	11.3
Other	19.7	19.6	19.7	21.7	22.9	22.4	24.2	24.8	26.2	27.8	28.3	31.6	30.7	29.7	29.1	28.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Capital and reserves[2]	23.4	21.0	18.9	20.0	19.3	19.7	20.1	18.6	19.0	19.7	21.2	21.5	22.3	24.9	25.8	26.8
Accumulated depreciation	25.2	24.4	25.0	23.9	22.2	22.4	21.6	21.4	20.9	19.6	17.4	15.3	16.4	17.9	19.0	20.5
Debt	48.7	51.9	52.9	53.1	55.6	55.1	55.0	56.3	56.4	57.1	57.7	59.5	57.1	52.9	50.8	48.2
of which: credit institutions	22.2	25.0	26.8	26.6	27.5	27.4	25.8	25.6	24.3	23.6	23.6	22.3	20.6	18.7	18.5	16.5
Other	2.7	2.7	3.2	3.0	2.9	2.8	3.3	3.7	3.7	3.6	3.7	3.7	4.2	4.3	4.4	4.5
Memorandum items																
Return on net capital	..	..	..	..	–2.7	–13.8	–8.4	–11.4	–8.8	–6.2	–7.9	–10.4	–9.8	–5.8	–1.5	2.5
Ratio of operating profit to capital employed	..	..	..	..	2.9	0.9	2.5	2.7	2.2	2.4	2.6	2.4	2.1	2.3	3.1	3.8

[1] Interest-bearing securities, cash, banks and PO accounts.
[2] Shareholders' equity plus severance pay and pension provisions.

Source: MEDIOBANCA, *Dati cumulativi di 1,504 società italiane*, 1986.

or replacement costs (CCA - current cost accounting). The application of these methods to the data of the Mediobanca group of firms did not significantly alter the trend of the ratio of current liabilities to current assets, whereas the adjusted data diverged from those of the original accounts for the ratio of long-term liabilities to long-term assets and for the ratios of flows to stocks. This is due to the nature of balance sheet data, obtained as the sum of flows that are recorded in different periods and which vary irregularly from year to year.

Furthermore, while the inflation adjustment of individual firm's assets and liabilities can be helpful in interpreting their balance sheets, the adjusted accounts of a group of firms are difficult to interpret because they are considerably affected by the relative prices used to deflate the values based on historical costs.

When real interest rates turned positive again at the beginning of the eighties and the real cost of debt drew close to the return on investment many firms no longer found it advantageous to finance their investment by borrowing and operating profits and financial charges were thrown out of balance.

Faced with these imbalances and the constraints deriving from the less accommodating stance of monetary and exchange rate policy, adopted with the aim of stimulating greater efficiency and productivity, firms undertook a radical reorganization involving both the elimination of obsolete and redundant plants and investment aimed at the incorporation of technological innovation and the search for more efficient combinations of the factors of production. Looking again at the Mediobanca group of firms and bearing in mind the problems inherent in comparing periods marked by high inflation and corporate divestitures and mergers, one finds that the ratio of gross tangible fixed assets to total assets amounted to over 60 per cent at the beginning of the seventies, fell to around 55 per cent in the mid-seventies and to below 45 per cent in the period 1983-85. Even when tangible fixed assets are considered net of depreciation to take some account of divestitures, the trend over the period 1970-85 is roughly the same.

The reorganization of production that large firms began during the 1979-81 recovery and intensified in the following years produced a sharp improvement in the return on investment, a result that also reflected better financial management. On the one hand, firms improved their cash management, thereby reducing their need to borrow and, on the other, they increasingly invested in financial assets. Indeed, between 1970 and 1985 the share of the latter in firms' total assets nearly doubled from 6 to over 11 per cent.

This increase in the corporate sector's demand for financial assets should not be attributed only to the scope for borrowing and reinvesting the proceeds in government securities, provided by the tax exemption of the latter, since it also reflected the reduction in fixed capital and stocks per unit of output achieved by the reorganization of production. The financial resources made available in this way, together with the higher profits earned, were gradually used to build up stocks of financial assets, partly in view of the high yields on government securities. In line with the development of financial aggregates in general, there was a shift in the composition of the corporate sector's portfolio towards longer maturities. Since 1970 the share of monetary assets (M2) in the flow of financial assets acquired by the corporate sector has fallen from 66 to 54 per cent, while that of government securities has risen from almost nothing to 37 per cent.

The main effect of this structural change in firms' assets was on their financial costs since, notwithstanding the increase in borrowing costs over the last five years, net financial costs have not risen significantly.

Excluding the two years 1981 and 1982, when the full effects of firms' financial restructuring had not made themselves felt, not only did the ratio of net interest payments to value added not rise compared with the average value of the preceding period but it actually fell over the last two years, especially for private sector firms.

The improvement in firms' finances and balance sheets primarily concerned larger enterprises. Those of small and medium size had already reorganized their production and had less scope for benefiting from better financial management since their liabilities and extra-industrial activities were generally on a smaller scale than those of larger firms.

The recovery in corporate profitability enabled firms to raise much more equity capital in the last three years, when it accounted for about 25 per cent of total external finance, compared with 14.5 per cent between 1975 and 1981. Excluding the share issues made by public enterprises, in part to cover their heavy operating losses, the share of equity capital in the total fund-raising of the Mediobanca group of firms rose from 14 per cent to nearly 20 per cent in the last two years.

1.3.2. - *International comparisons*

The data on the liabilities of firms in France, the Federal Republic of Germany and the United Kingdom show that financial restructuring has been under way since the beginning of the eighties, above all in Germany and the UK, with borrowing from the credit system decreasing in line with the rise in self-financing.

The process was especially pronounced in Germany, where the share of borrowing from credit institutions in total liabilities fell from 49 per cent in 1980 to 39 per cent in 1985.

By contrast, the share of equity capital rose between 1975 and 1985 in Germany and the United Kingdom, from 29 to 49 per cent in the latter. A similar trend emerges when new share issues are considered; in the United Kingdom these accounted for nearly 40 per cent of new external financing.

A summary indicator of the effects of firms' financial restructuring and of the increase in self-financing is provided by the ratio of the corporate sector's financial balance to GDP. In France and Germany this ratio has remained negative but has been much smaller since 1983, while in the United Kingdom it has been positive since 1981.

1.4. - The household sector

1.4.1. - *Households' assets and liabilities*

In the period 1970-85 the financial balance of Italian households recorded a structural surplus that averaged nearly 19 per cent of the sector's gross disposable income and 75 per cent of its saving — 67 per cent in 1970 and 84 per cent in 1983-85 (Table 1.7) (when comparing flow-of-funds and national accounts data, it needs to be remembered that the latter include most unincorporated business enterprises among households and exclude non-profit-making institutions).

As discussed above, the nominal propensity for financial saving tends to rise with the rate of inflation. Adjusted to take account of this, it averaged around 7 per cent, with negative values in 1974 and 1980. The fluctuations in the adjusted values of the propensity for financial saving reflect the changes in the real yield of financial assets, which, net of tax, was negative from 1972 to 1982.

TABLE 1.7

HOUSEHOLDS' SAVING AND FINANCIAL ASSETS
(percentages)

	Propensity to save[1]	Propensity to financial saving[2]	Financial saving/total saving[3]	Financial wealth/disposable income[4]	Adjusted propensity to save[5]	Adjusted propensity to financial saving[6]	Nominal interest rate[7]	Real interest rate[8]	Consumer price inflation[9]	Increase in prices of dwellings[9]
1970	22.5	15.0	66.6	133.9	18.3	10.8	5.3	0.3	5.0	5.2
1971	23.9	18.0	75.4	136.4	20.0	14.1	5.1	0.2	4.9	– 0,8
1972	24.9	19.8	79.3	142.4	18.3	13.2	4.8	– 4.6	5.7	13.3
1973	24.8	17.7	71.6	137.9	14.0	6.9	4.8	– 9.1	10.8	36.0
1974	24.1	16.9	70.1	125.0	4.8	– 2.4	6.3	–12.1	19.2	32.4
1975	26.5	21.3	80.2	121.1	16.4	11.2	7.0	– 6.1	17.0	22.9
1976	26.2	19.3	73.5	119.5	9.1	2.2	8.7	– 9.6	16.7	22.9
1977	26.1	18.4	70.7	116.7	15.1	7.4	10.0	– 2.1	18.4	15.7
1978	27.3	20.0	73.1	119.6	17.7	10.4	8.9	– 3.8	12.1	14.5
1979	26.5	19.0	71.6	120.1	10.3	2.8	8.7	– 9.9	14.8	22.0
1980	24.6	16.7	67.9	120.6	6.9	– 1.0	10.1	– 8.5	21.2	29.3
1981	24.8	17.9	72.1	119.6	10.0	3.1	12.4	– 3.3	19.5	22.4
1982	24.7	19.1	77.4	120.3	10.8	5.2	13.3	– 2.4	16.5	22.8
1983	24.4	20.5	84.1	128.3	12.9	9.0	12.8	0.9	14.7	16.1
1984	25.1	21.2	84.4	136.4	16.0	12.1	11.7	2.1	10.8	6.7
1985	24.6	20.7	84.0	151.9	15.5	11.6	10.7	3.7	9.2	3.7

[1] Gross saving/gross disposable income (defined as consumption + gross saving).
[2] Financial balance/gross disposable income.
[3] Financial balance/gross saving.
[4] End-year net financial wealth/gross disposable income.
[5] (Gross saving − loss of purchasing power of financial wealth)/gross disposable income.
[6] (Financial balance − loss of purchasing power of financial wealth)/gross disposable income.
[7] Weighted average yield after tax on money and interest-bearing securities; averages of the figures for four quarters.
[8] Nominal interest rate − rate of consumer price inflation in the following half-year; four quarters' averages.
[9] Average annual change.

On the basis of the foregoing adjusted financial flows, households' financial wealth first declined in relation to disposable income, from 142 to 117 per cent between 1972 and 1977, remained close to this value until 1982 and then rose to 152 per cent in 1985. The recovery in this ratio at a time when inflation was gradually coming down (it slowed from 21.2 per cent in 1980 to 9.2 per cent in 1985) was fueled by the huge deficits of the public sector and, in 1985, by the large rise in the value of the shares households held, either directly or by way of investment funds.

The share of households' financial assets in the private sector total averaged 70 per cent between 1969 and 1979, fell to 64 per cent in the following five year period and to 58 per cent at the end of 1985, primarily as a result of the sharp rise in the price of shares, which the financial statistics indicate as being mostly held by enterprises. In Germany both the level and the trend of this ratio were similar, while in France and the United Kingdom the level was higher and more stable.

In the early seventies Italian households were faced with restrictions on investment abroad and a very narrow share market; accordingly, a large proportion of the financial assets they acquired were in the form of money and medium- and long-term securities, respectively 60 and 11 per cent of the total flow in the period 1970-73.

After 1974 the high rate of inflation and the collapse of the market for fixed rate securities led to a growing proportion of financial saving being invested in liquid assets (M2) and, in particular, bank deposits. This provided the resources for the growth of banking intermediation that was a feature of the seventies. Underlying this shift, there was not only the narrow choice of alternative financial instruments but also the closing of the yield differential between fixed rate securities and bank deposits when the expectations of capital losses on the former are taken into account. Over the four years 1974-77 the share of M2 in the gross flow of households' financial assets averaged 73 per cent, while that of medium- and long-term securities fell to 1 per cent.

Households reacted favourably to the process of financial innovation initiated in the second half of the seventies with the development of the market for Treasury bills, achieved by increasing their real yields. From virtually nothing before 1975, the share of this instrument in the flow of households' financial assets rose to 32 per cent in 1980-81. This first advance was followed by the development of the market for Treasury credit certificates, which were issued at floating rates, or with their principal indexed to the GDP deflator, denominated in ECUs, or

convertible .into fixed rate securities. Innovation in the instruments offered by the government was matched by other operators (with the introduction of bankers' acceptances, certificates of deposit and atypical securities, etc.), though the success of such instruments was limited in volume terms, in part owing to their tax treatment. Households gave a much more favourable reception to Italian investment fund units, which accounted for 2 per cent of their financial assets at the end of 1985, a figure that will have risen further in 1986.

The substitution of money with alternative financial assets is in line with developments in the three other European countries considered and appears closely linked to the contraction in credit intermediation, which was especially marked in the eighties and caused primarily by the entry into the market of new intermediaries and the introduction of new instruments.

The instruments that replaced money in households' portfolios differed in each country. In Germany the proportion of short-term securities remained negligible in the period 1975-85, while there was a swing towards bonds and shares. In the United Kingdom the shift was primarily towards forms of supplementary social security managed by insurance companies and pension funds. In France the shift was towards securities of all maturities and foreign assets. In terms of stocks, in which capital gains deriving from variations in the exchange rate are reflected, the share of the latter item increased from 4 to 12 per cent between 1975 and 1985.

A concluding remark on government securities; while these have taken on considerable importance in the portfolio of Italian households, their share of households' financial assets in the other three countries appears to have remained small, although accurate disaggregated data are only available for the United Kingdom.

1.4.2. - *Households' net wealth*

Households' financial choices and, in particular, their decisions on the allocation of saving between real and financial assets depend to a considerable extent on the amount of net wealth. Accordingly, it appeared useful to present some estimates of this variable, among other things to gauge the ability of Italian households to absorb the financial assets that will be issued in the coming years as a result of the persistence of large budget deficits.

The key features of Italian households' wealth in the period 1975-85 can be summarized as follows: the large share of tangible assets (constantly above 70 per cent); the small proportion of liabilities (around 2 per cent); and the stability of the ratio of net wealth to disposable income (around 4.4-4.5 per cent), in line with both life-cycle theory and the results of empirical studies in other industrial countries.

In view of the predominance of tangible assets, the fluctuations in this ratio during the period were mainly attributable to changes in property prices, which rose sharply between 1979 and 1981 and remained flat in 1984-85. The share of consumer durables varied on average between 7 and 8 per cent and came to exceed that of agricultural land, which fell by more than a half over the period.

An important contribution to the nearly nine-point fall in the share of real wealth between 1982 and 1985 was made by the high real rates of interest that ruled in this period. They not only encouraged financial investment, especially in government securities, but also made investment in housing relatively less advantageous and simultaneously caused property prices to weaken.

The difficulties inherent in any international comparison of statistics as a result of different definitions and methods of compilation are especially pronounced in the case of tangible assets. It is nonetheless worth making a comparison with the wealth statistics for France, Germany and the United Kingdom in view of the role of this variable in consumption and investment decisions (Table 1.8). Together with broad similarities between households' wealth in the four countries, there are also some significant differences in its composition.

The main similarities are the value of the ratio of wealth to disposable income just above 4 (except for France) and the share of tangible assets in the total (more than two thirds on average).

By contrast, the share of housing is higher in Italy than in the three other countries, while that of agricultural land and consumer durables is small, especially compared with Germany. In turn, Italian households' liabilities were also very much smaller than in the other countries (though the figure for Italy only covers units of consumption). Liabilities showed a tendency to increase in both France and the United Kingdom, where this can be attributed to the rise in mortgages, which account for more than 90 per cent of long-term liabilities.

TABLE 1.8

THE COMPOSITION OF HOUSEHOLDS' WEALTH
(percentages)

	FRANCE		GERMANY	UNITED KINGDOM			ITALY		
	1975	1979	1977	1975	1980	1984	1975	1980	1984
Real assets	76.3	76.2	76.0	64.8	67.4	60.8	72.1	73.9	69.7
Dwellings	53.5	55.2	39.2	47.5	51.2	48.1	58.4	59.7	58.5
Agricultural land	15.1	13.3	22.8	3.7	4.4	2.9	7.1	6.8	3.8
Consumer durables	7.7	7.7	14.0	13.6	11.8	9.7	6.6	7.3	7.4
Financial assets	34.2	36.8	40.3	49.6	46.9	56.4	30.4	28.1	32.2
Monetary assets	23.0	24.1	23.0	20.7	18.3	18.6	18.9	16.9	16.3
Government securities	—	—	—	2.9	2.1	2.0	1.0	3.7	8.5
Equity instruments[1]	6.1	6.6	2.2	9.0	6.6	8.5	2.0	2.2	2.4
Technical reserves and pension funds[2]	2.4	2.5	8.6	12.0	15.8	22.5	6.0	4.3	4.1
Other assets	(*) 2.7	(*) 3.6	(*) 6.5	5.0	4.1	4.8	2.5	0.9	1.0
Liabilities	10.5	13.0	16.2	14.4	14.3	17.2	2.6	2.0	1.9
Long-term liabilities	8.7	10.9	15.0	9.5	9.0	11.1	2.0	1.3	1.3
Other liabilities	1.8	2.1	1.2	4.9	5.3	6.1	0.6	0.6	0.6
Wealth	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memorandum items:									
Wealth/income	3.6	3.6	4.0	3.8	4.0	4.6	4.4	4.6	4.5
Wealth/income[3]	(4.0)	(4.5)	(4.4)	(4.1)	(4.2)	(4.8)	(. .)	(. .)	(. .)

(*) For France and Germany, Other assets includes claims on the public sector.
[1] For the UK, includes the units of unit trusts and for Italy the units of Italian and Luxembourg-based investment funds.
[2] For Italy, includes severance pay and pension provisions.
[3] In this case wealth includes producer goods.
Source: "The Wealth of Italian Households (1975-85)", BANCA D'ITALIA, *Economic Bulletin*, No. 3, 1986.

Apart from Italy, the United Kingdom is the only other country for which recent data are available (1984) and it is interesting to note that the share of tangible assets in net wealth decreased in both countries during the recent period of disinflation (1980-84), reversing the trend of the previous five years. This change can be attributed in large part to the deterioration in the relative prices of property and agricultural land.

Section 2. - The demand for financial assets and their supply

2.1. - Portfolio choices in an innovatory environment

The aim of presenting a summary of the main components of financial wealth in the Italian economy and their determinants in the coming years is linked to the need to explain the demand for financial assets, and especially that for government securities, within the framework of a single model. Traditionally, the demand for each category of financial assets has been explained by recourse to portfolio choice theory.

As discussed earlier, the whole financial system and the structure of financial wealth are both undergoing far-reaching changes. It is therefore reasonable to ask whether, and to what extent, portfolio theory is applicable in these conditions of financial innovation, especially in view of the likelihood that the innovatory process will continue.

This process has undoubtedly been stimulated by the turbulent events of the last fifteen years. In particular, the high rate and variability of inflation have modified economic agents' perception of the risks inherent in financial wealth. The range of possible combinations of nominal interest rates and inflation rates has widened considerably, while operators attribute a lower probability to the occurrence of any given rate. The increased uncertainty surrounding the rate of inflation has been reflected in stock exchange quotations.

Coupled with widespread aversion to risk, these conditions made it prohibitive for issuers to offer the fixed rates needed to induce savers to run the risk, in the medium and long term, of variable stock exchange quotations as well as uncertain values relative to goods and services and other forms of wealth.

The reaction of the financial system in Italy, as elsewhere, was to offer savers new financial instruments with risk combinations different from those normally brought together in traditional securities. For example, the nominal security yield can be partly fixed and partly linked to a short-term interest rate or to the rate of inflation. In addition, the division between a fixed and a variable component can be limited to a part of the life of the security, with the risks being recombined for the rest.

The aim of redistributing risk also underlies the process of securitization that has been a feature of the activity of some financial

intermediaries. Specifically, this process involves the loans recorded among the assets of the intermediary being brought together in a portfolio and the rights or claims in respect of the portfolio as a whole being traded in the securities. The related risks are thus distributed between an insurer, who incurs the credit risk, and an underwriter of the securities, who bears the interest risk. The result is that the loans themselves become more liquid. It is worth noting in connection with securitization of financial intermediaries' assets, that the sum total of final lenders, basically households and the rest of the world, continue to incur the same risks as before, only directly instead of indirectly. Contrary to the facts, securitization may give the impression that the overall risk has somehow been reduced.

A similar approach underlies the working of investment funds, probably the most important institutional innovation in the Italian financial system since the Second World War. The resources of these funds are invested in financial assets with combinations of risks that appear to be only partially correlated, or at any rate to have an average correlation not higher than that existing within the totality of financial assets which constitute the market.

Most of the recent innovations in financial markets can be seen as involving the unbundling and/or rebundling of the risks attaching to the transfer of wealth over time. The aim of these innovations is to produce financial instruments and forms of intermediation that will meet the requirements and needs of the different segments of the market. To the extent that the requirements of the demand for financial assets can be met better than before, there can be an impact effect with lower costs for issuers and strong growth in intermediation business, with the ensuing advantages for intermediaries. The outcome is a "menu" of real and financial assets better suited to its purpose, which is to transfer wealth over time, maximizing its expected final value in real terms, conditional on operators' (subjectively held) probability distribution of the outcomes of possible future economic events.

In conclusion, the recent innovatory phase can be seen as the expression of the same portfolio choices; in other words, the validity of this approach as the basis for the analysis of behaviour in the face of financial innovations appears to be confirmed. Even if economic and financial developments had been less precipitous, the natural coming of age of operators and markets would have produced a considerable diversification of financial products. This view can be justified on the grounds both of the trend towards deregulation and of the advance and

spread of information and telecommunications technology. These factors have:

a) increased knowledge about the distribution of receipts and outlays over time and developments in domestic and international markets;

b) reduced transactions costs; and

c) opened up opportunities for earning profits and diversifying risks that have allowed and encouraged operators to make radical changes in the management of their monetary and financial resources.

Since the potential for financial innovation inherent in the advances in information and telecommunications technology does not appear to have been fully exploited, the innovatory phase is likely to continue. This certainly does not mean that it may not slow down in some markets compared with the recent past, especially if the economic and financial environment becomes less uncertain and risky. If this is the case, the intensity of innovation on the various maturity horizons and among individual financial instruments may well differ from what we have seen over the last ten years.

Further improvement in information systems and reductions in transactions costs will make it advantageous to create and exchange "new" financial instruments that will offer new combinations of risks compared with those previously or traditionally supplied. Financial innovations can be introduced over the whole range of maturities, including money. One reason for this is the spread of financial instruments that are not money in the usual sense but which are nonetheless accepted as means of payment or accumulated for precautionary motives.

Even if the "menu" of choices grows longer than it is today, it will never cover all the possible circumstances or economic and political situations that will arise in the future. Markets need real resources if they are to work and financial assets are created if at least one of the following conditions is satisfied: the new instrument permits a reduction in the cost of trading financial wealth; it can be placed directly with final holders (households and non-financial companies), thereby reducing the commitment of intermediaries' equity capital; and the yield offered by the new financial assets has a negative covariance with the return earned on alternative, existing assets. Further, there has to be the prospect of a sufficiently deep market for the new instrument so that it will be as liquid as others supplied by the same issuer or the same category of issuers.

Another important development affecting the Italian financial market is the liberalization of capital movements by Italian residents, discussed in detail in Section 3. Looking ahead, the range of financial choices open to operators will be increasingly different from today's; current regulations still require residents acquiring foreign assets to make a non-interest-bearing deposit equal to 15 per cent of their value. In practice this deposit constitutes an extra transactions cost, though it has been considerably reduced over the last twelve months.

Most of the results of the empirical analyses (primarily concerning US and Canadian dollars, Deutsche Mark and pounds sterling) indicate that financial assets denominated in different currencies and covering the range of actual maturities are seen by the market as involving relatively independent risks, so that they are imperfect substitutes. The perception of risk differentiation thus justifies the concurrent demand of individual operators for assets denominated in different currencies over the maturity spectrum.

It is reasonable to expect that a similar argument will hold for financial assets denominated in lire. Accordingly, from a national viewpoint the liberalization of capital movements by Italian residents can be seen as equivalent to their subscribing "new" financial assets denominated in foreign currencies.

2.2. - The factors affecting portfolio equilibrium

The availability of new financial instruments, in the sense defined above, will modify the financial structure of the economy in ways and with effects that cannot be determined *a priori*. For example, two financial assets with a high negative risk correlation may prove to be complementary. In other words, an increase in the expected real yield on one may stimulate the demand for a combination of both.

Even in the absence of a similar correlation, the income effects of an increase in the expected yield on one financial asset can generate extra demand for other assets. An example of this type of innovation is the availability, in sizable quantities thanks to regular issues, of medium-term bonds with various combinations of fixed coupons and variable coupons linked to a short-term interest rate or the rate of inflation. Changes in the range and distribution of financial assets affect the yields on the various instruments or, in other words, modify their relative prices and possibly their absolute prices as well. Yields on old

and new instruments move to the pattern that will induce the market to hold the new stock composition, with an effect on the monetary policy transmission mechanism.

Changes in transactions costs and/or in the taxes on financial assets are accompanied by changes in both the expected yield and the corresponding variance, thereby modifying the desired composition of portfolios, notably as regards maturities and denomination in lire or foreign currencies.

It is worth noting that even though the changes in the financial structure may be large in quantity terms, they occur gradually. They are likely to involve a series of shifts, which may be accompanied by yield volatility. This makes it impossible to explain interest rates exclusively in terms of the development of the so-called economic fundamentals.

Up until now we have avoided making any reference to estimates of the main parameters regarding the financial structure, and we shall continue to do so. It needs to be remembered when using such estimates that they are based on the assumption that the structure of the sector described remains virtually unchanged over the reference period, except for analytically simple trends — *e.g.*, linear trends — that can be introduced in the estimation model.

The problem of changing parameters is very much present in the case of the financial sector, in view of the substantial innovation that has occurred. It would therefore be rash to use parameters estimated on data referring to the recent period of far-reaching change and extrapolate them to provide a quantitative indication of the financial structure that will emerge in the years to come. This does not mean, of course, that such estimates are useless or unimportant for other purposes.

The unbundling and rebundling of risks, the basis or at least a major feature of the present phase of financial innovation may require or permit the transfer into the future of each operator's wealth to be made with a variety of financial instruments, employed in an appropriate sequence. This implies a plurality of transactions over time and an increase in their volume per unit of time. The support of sufficiently diversified and deep primary and secondary markets becomes indispensable.

A priori considerations, backed by the available empirical evidence, indicate that markets, and especially the secondary market (see Section 5), perform a function of gathering and disseminating information that is particularly important for financial innovations. The experience of regular and professional operators generally results in their

possessing a better information base than the rest of the market. If the functions and institutions of the latter are adequately diversified, other operators infer the assessments of these operators from prices, a fact that is of special benefit to the marketing of innovative products.

It is necessary to take account of the liquidity and precautionary motives that underly the demand for securities, insofar as they play an important role in determining households' and intermediaries' demand for some financial assets. For example, short-term Treasury paper is particularly well suited to satisfying liquidity and precautionary requirements in view of the relatively low transactions costs and risks they entail in nominal terms.

As a rule, traditional portfolio theory assumes that the yield on real and financial assets is a random variable. Conversely, the quantity demanded is the result of operators' choices. In some markets, however, there are rules, patterns of behaviour or "de facto" situations that actually determine prices. This is at least partly true of the demand for liquid and precautionary assets in Italy, but may well exert a material influence on the markets for commercial bank credit, mortgages and interest-bearing securities. In these cases, quantities become random variables.

The effects of the growing liberalization of capital movements by residents in Italy will now be considered. In view of the external current account balance, the foreign exchange risk aversion of operators, including the government, and the rigidity of the latter's funding requirements, residents' net purchases of foreign assets in the place of assets denominated in lire will have to be matched by the placement with non-residents of an exactly equal amount of lira securities. This implies an equal increase in the net supply of financial assets denominated in lire on international markets.

It can plausibly be assumed that Italian operators' demand for foreign currency financial instruments will have little or no effect on their prices. The effects of the liberalization of capital movements will be restricted almost exclusively to the prices of assets denominated in lire. Extrapolation of the results of empirical analyses of other multicurrency situations to Italy suggests that non-residents' increased holdings of lira securities could lead to a fall in their price or, in other words, to an increase in their yield and/or a depreciation of the exchange rate of the lira.

It goes without saying that this should not be interpreted as a forecast of the effects the liberalization of capital movements will have

on the exchange rate of the lira, an issue that is discussed in Section 3. It would be doubly wrong to make such an assessment without considering the state of the current account of the balance of payments. Rather, the foregoing serves to bring out the increase in the role of the exchange rate compared even with interest rates (or better the yield curve) as a result of greater freedom of capital movements.

This leads to the conclusion that it will be advisable, indeed indispensable, to maintain a wider fluctuation band for the lira in the EMS. If it were to be narrowed, the effects of liberalization would necessarily be concentrated on the yields of financial assets denominated in lire and/or on the foreign currency reserves. Such a development is to be avoided since, among other things, the ensuing substitution and complementarity relationships between lira and foreign currency securities would not be immediately established, but would emerge through a series of portfolio adjustments over a period of time that cannot be determined *a priori*.

2.3. - THE INTERACTION BETWEEN THE SUPPLY AND DEMAND FOR FINANCIAL ASSETS

At any given moment economic agents are the owners of wealth that is invested in real and financial assets and equal in amount to the saving they and their predecessors in title have accumulated. This amount is also the result of past portfolio choices and therefore of past decisions to buy and sell assets and the related capital gains and losses. The desired amount of wealth is the main determinant of the demand for financial assets. Specifically, the prevailing theory and the available evidence indicate that the aggregate wealth of an economy depends basically on the length of the working life, the population and income growth rates and, in the short run, the real yield of wealth itself.

At any given moment, the amount of wealth and its distribution among the various types of assets are the result of past production, saving and portfolio choices. At the same moment, a new set of related variables (prices, interest and exchange rates, production and incomes) becomes known with certainty, while they had been uncertain when past decisions were taken. It also becomes possible to identify the shocks currently affecting the economy, *i.e.* the outcomes that deviate from past experience.

The newly available information might imply a revision of the previously held expectations concerning the future course of these

variables. At the same time the primary and secondary markets for real and financial assets handle primary flows — stemming from savings, investment, the balance of payments on current account, and government borrowing — together with the secondary flows arising in connection with the rearrangement of existing portfolios as well as the assets and liabilities management performed by both private operators and the authorities.

The importance of secondary flows must be stressed as households and enterprises are able to mobilize resources in excess of their disposable incomes, as a rule up to the full amount of their net worth. The placement of wealth interacts with other endogenous variables, such as production, consumption, investment, net exports, inflation and exchange rates, as well as with the formation of expectations concerning the future time pattern of the same variables.

Current incomes thus help to determine the saving of households and enterprises, private sector investment, the budget deficit and the balance on external current account; at the same time, the prices of goods and services, exchange and interest rates influence consumption and investment expenditure both in the domestic economy and abroad.

In the foregoing process of wealth placement, it is possible for the volume of stock exchange trading to be extremely large, while prices change little or not at all — the exchange of securities satisfying the different needs of operators concerning the transfer of their wealth into the future, while expectations concerning future time patterns remain unchanged.

Conversely, prices may change very substantially with only a low turnover since a major shift in expectations can lead the market to reassess asset values radically.

It is also possible for a high turnover to be coupled with large changes in prices. In particular, there may be excess demand for some securities and excess supply of others. The variations in relative prices serve to correct these imbalances. In view of the structure of risks, operators tend to increase their least costly debt and reduce their recourse to forms of borrowing that become more expensive, while building up their holdings of securities with the highest expected yields and running down those that lose their appeal.

When the total demand for securities is seen *ex ante* to fall short of the supply, the prices of all financial assets immediately weaken, thereby raising (average or expected) real rates of return on wealth. In the short run, this should lead to an increase in the propensity to save, bearing in mind also the additional effect of the reduction in the market value of wealth caused by the rise in interest rates.

2.4. - Financial stability and instability

The situation is different when the size of the public sector borrowing requirement generates a volume of debt roughly in line with households' demand for wealth. This implies that for some considerable time the public debt will grow faster than the wealth desired by households.

The same conclusion can also be reached independently of the portfolio model adopted here. It is sufficient to assume that a limit exists to the desired ratio of wealth to income and that this limit is below that tending to emerge *ex post* from the growth in the public debt generated by the current level of the budget deficit. Such a situation can occur even if the ratio of public debt to GDP tends towards a finite value with the persistence of the present ratio of the borrowing requirement to GDP. Though finite, this trend value can be so high as to imply a volume of financial assets (in relation to GDP) that exceeds the level considered sustainable in the long run.

When the ratio of households' financial wealth to disposable income is rising rapidly towards such levels, the economy enters into a state of financial instability. A sudden loss of confidence, fear of measures freezing or expropriating the saving accumulated or a speed-up in inflation can be accompanied by sharp and undesired increases in the monetary financing of the government borrowing requirement. The size of the latter may be an increasing function of the ratio of the public debt to GDP.

This can lead to equally sudden and undesired increases in demand for tangible assets and for goods and services. In turn, these fuel inflation, cause the external current account to swing into deficit and generate capital outflows, both in visible forms and in the invisible ones associated with shifts in leads and lags.

On the other hand, the aforementioned ratio of wealth to disposable income may result in the growth of the public debt being accompanied by a decrease in the accumulation of other forms of wealth. The fall in private sector investment accelerates the crowding out process. As the expenditure of the private sector on gross fixed investment declines, the market's valuation of plant and production facilities also falls in the aggregate. As the yield on the public debt is raised, the borrowing requirement and the debt itself expand increasingly fast. It is quite possible that the situation will become unsustainable.

It needs to be stressed that the above is not a forecast of a sequence of events to which the present state of Italian public finances will give rise. Rather, it serves to highlight the fact that if the present ratio of the borrowing requirement to GDP persists, there will be a growing risk of:

a) the real value of the public debt being eroded by inflation; or

b) the other component of wealth (*i.e.* the market value of industrial assets) being reduced as a result of financial implosion.

The first risk appears less likely to materialize than in the past since a large part of the nominal value of the public debt carries floating rates linked to short-term yields, which respond rapidly to changes in the rate of inflation. It nonetheless remains true that if the size of the public debt were to grow beyond the potential capacity of the portfolio of private operators to absorb it, one or other of the forms of financial instability described above would be bound to emerge.

The Committee considers it indispensable that the authorities should act with great firmness and determination in their efforts to restore public finances to a sound footing, in order to prevent either of these extreme situations from developing.

2.5. - The rehabilitation of public finances, the "Goria plan" and the sustainability of the public debt

The pace of the growth in public spending in Italy has been independent of that in revenues and, since the end of the sixties, of the trend growth in national income. In the sixties the revenue shortfall was kept small and the borrowing requirement remained around 2-3 per cent of GDP. The deficit began to widen in the early seventies, with the borrowing requirement rising to 6 per cent of GDP, followed by a jump to 12 per cent in the second half of the decade and a peak of over 16 per cent in 1982. There was thus a long series of structural deficits, matched by a growing accumulation of debt in real terms.

The ratio of the public debt to GDP in Italy rose from 39.0 per cent in 1960 to 44.2 per cent in 1970, to 66.9 per cent in 1980 and broke the 100 per cent barrier in 1986 (on the basis of the old national account series). Even though it would be more correct to relate the public debt to wealth, the lack of data and official statistics on the latter have resulted in GDP, the main explanatory variable of wealth, normally being used as a proxy.

The 1986 state sector borrowing requirement was in line with the target of 110 trillion lire. The deficit net of interest payments appears to be falling, both in absolute terms (from over 46 trillion lire in 1985 to 37 trillion in 1986) and in relation to GDP (from 7 to 5 per cent). In conjunction with the improved conditions in the world economy, the steps taken in 1986 contributed to progress, but it will be necessary to persist with the rehabilitation of public finances. This goal would be achieved by rigorous adherence to the three basic principles laid down by Giovanni Goria, the Minister of the Treasury, and approved by Parliament in September 1985:

a) maintenance over the coming years of the 1986 value of the ratio of tax revenues to GDP;

b) zero growth in real terms of current expenditure net of interest payments (with 4 per cent growth in nominal terms, in line with the target inflation rate); and

c) real growth in capital spending at a rate not exceeding that of real GDP in 1987, and slightly below this rate in the following years (nominal growth for 1987 is forecast at 7.5 per cent and real growth at 3.5 per cent; in the subsequent years the real growth rate is reduced by 0.5 percentage points).

The application of these three rules should result in a reduction in the borrowing requirement net of interest payments, which, accompanied by a falling rate of inflation, would significantly curb these payments.[1] The aim, established in the light of the government's macroeconomic scenario, is to eliminate the borrowing requirement net of interest payments by 1990.

Even though the government programme is geared to achieving further progress in the rehabilitation of public finances, with a 10 trillion lira decrease in the state sector borrowing requirement to 100 trillion lire in 1987, it is too early to speak of a reversal of the trend of government spending. There is still uncertainty about the medium-term development of the macroeconomic variables and public sector balances. In particular, the conditions for a stable ratio of public debt to GDP are far from having been achieved.

[1] *Obiettivi e strumenti della manovra di bilancio per il triennio 1987-1989*, document presented by the Minister of the Treasury (Goria) in collaboration with the Ministers of the Budget (Romita) and Finances (Visentini), Rome 1986.

The sequence of deficits fueling the accumulation of public debt has chronic overtones. The rise in spending is not attributable to extraordinary events, but to behaviour of a "structural" nature, such as the adoption of legislation with no assessment of its long-term effects and the persistent circumvention of constitutional and accounting constraints. Revenues have been increased with considerable delay and the total tax burden has been raised in relation to GDP in large jumps over just a few years, thereby aggravating taxpayer resistance. There appears to be little scope for further adjustment of the budget deficit on the revenue side, especially in view of the unequal distribution of the burden caused by the high level of evasion.

The increases in expenditure, combined with the delays in fiscal policy action and the decision to finance the government borrowing requirement with non-monetary means, have led to a rapid expansion of the public debt and a consequent sharp rise in interest payments and a further increase in total expenditure. The problems raised by a continuous expansion of the debt are nonetheless much more complex. This has been made clear in many studies, including the summary report of the Technical Committee on Public Expenditure.[2] Even when the total borrowing requirement, gross of interest payments, is held stable in relation to GDP, the limit to this ratio (arithmetic sustainability) is so high that not only it cannot ensure the stability of financial wealth over time but it is not even sufficient to guarantee continuance of the conditions preventing explosive growth (economic sustainability).

The trends of the ratio of the public debt to GDP can be simulated with different macroeconomic scenarios and hypotheses regarding public finances. If the rules laid down in the Minister of the Treasury's plan are applied and the budget deficit net of interest payments completely eliminated by 1990, not only is the ratio of the public debt to GDP found to tend towards stable values, but the long-term problem is also solved because the ratio would begin to fall towards zero.

Furthermore, the analyses based on such simulations indicate that monetary policy, regardless of whether it is pursued independently of the Treasury's borrowing requirement or promotes its financing, cannot produce a satisfactory improvement in public finances. Monetary policy on its own is powerless to counter an explosion of the debt to GDP ratio.

[2] COMMISSIONE TECNICA PER LA SPESA PUBBLICA, *La spesa pubblica in Italia*, Istituto Poligrafico e Zecca dello Stato, Rome 1986, pp. 55-56.

In the view of the Committee this implies a second imperative for the plan to stabilize public finances, that the borrowing requirement net of interest payments should be eliminated in a relatively short time (3-4 years).

While it is advisable to avoid exposing the economy to sharp changes in the level and composition of demand, and for income to grow in line with its potential so that the burden of adjustment will be as light as possible, it is also necessary for the stabilization plan to be implemented over a relatively short period, albeit with the necessary gradualism.

In the first place, this is important for the credibility of the plan itself. Secondly, it appears advisable in the light of the foregoing considerations on financial stability to limit the further growth of the public debt in relation to GDP. Thirdly, this is confirmed by the experience gained with the multicurrency situations that have been systematically analyzed. Such analyses show that, other things being equal, external depreciation and/or a reduction in the interest rate differential of a currency are positively correlated with the excess rate of growth in the supply of financial wealth denominated in that currency over that of financial assets denominated in foreign currencies.

On the basis of the rehabilitation assumed above, it is reasonable to presume that it will be possible for any *ex ante* imbalances between the demand for financial assets and their actual stock to be eliminated *ex post* by changes in the relative and absolute prices of financial assets with respect to their expected yields and the consequent wealth effects.

A basic role in this adjustment process will be played, of course, by both sterilized and unsterilized monetary policy interventions over the whole range of maturities, and especially by those of an open market nature. The demand functions for real and financial assets of households, enterprises, the rest of the world and, in particular, financial intermediaries do not necessarily correspond with their medium-term choices. The situation at any given time is modified towards the desired one through adjustments, whose speed depends on the costs they involve, which are not simply transactions costs in the strict sense.

In today's national and international environment the working of the Italian financial system appears to be increasingly influenced, indeed dominated, by market mechanisms and not by direct controls or objectives expressed in terms of credit. This explains the focus here on the portfolio model, which can embrace both financial innovation and the integration of Italy's financial markets through the liberalization of

capital movements. Equilibrium in the financial system and growth in economic activity can be achieved without problems as long as the financial structure respects the rules that follow automatically from the basic principles of the market mechanism. Only within such a framework will it be possible to integrate the Italian financial system into the international one, which, in turn, requires that public finances should be simultaneously stabilized. It is necessary at this point to reiterate that this stabilization is a precondition for the wealth of the Italian economy to grow and shift towards a composition that will be inherently sustainable.

The stabilization of public finances prevents the growth in the public debt from exceeding the capacity for its absorption corresponding to the amount of wealth that economic agents wish to accumulate. Furthermore, only if such a stabilization programme has been implemented will the economy be in a position to cope with disequilibria or shocks of external origin by means of the built-in stabilizing properties of the economy itself, its financial wealth and economic policy action. In the alternative case of a failure to stabilize public finances, the Italian economy would find itself on a course marked by growing financial instability, the ultimate consequences of which have been described above.

Section 3. - International financial integration and exchange policy

3.1. - Exchange policy and financial integration: the Italian situation

How and how far the Italian economy is integrated into the international financial system are important factors affecting the formation and allocation of financial wealth. In addition, these factors may exert a powerful influence on some of the problems with which this Report is concerned, such as the financing of the public sector.

It therefore seems necessary to identify the most desirable path for international financial integration of Italy, how such a path may be or become compatible with the financial scenario outlined in Sections 1 and 2, as well as the exchange policy that would foster its attainment.

It needs to be observed at the outset that since the beginning of the seventies the Italian economy has taken part asymmetrically in the process of international financial integration. While there has been a considerable increase in the share of foreign liabilities in the total liabilities of households and non-financial firms, there has been a marked decline in the corresponding share of foreign assets.

This is largely the result of a series of exchange policy measures aimed at preventing or discouraging the acquisition of foreign financial assets and encouraging or imposing borrowing abroad. In turn, this exchange policy, which has also hindered the expansion of Italian banks into international financial markets, reflected the aim of financing at least a part of the external current account deficits of the seventies — initially caused by Italy's divergence from the macroeconomic path followed by the other leading industrial countries and subsequently by the 1973 and 1979 oil shocks — while the lengthy process of adjustment went ahead.

In the last few years, and especially since 1984, a start has been made on changing the course of exchange policy by rationalizing and liberalizing it. However, together with France, Italy remains the major EEC country with the most protectionist exchange regime.

3.2. - Towards greater financial integration through exchange liberalization

Both from a national and from a Community viewpoint, it appears desirable that Italy should be more fully, and above all less asymmetrically, integrated into the international financial system.

In a national perspective, there is greater awareness of the effects of prolonged exchange protectionism on the economy, especially through the costs it imposes on firms and final intermediaries.

In the second place, it is increasingly clear that the growing international competition between the financial industries and centres of the various countries results in the maintenance of a high degree of exchange control imposing a serious competitive disadvantage.

In the third place, it should be emphasized that the (now largely completed) adjustment of the Italian economy would be given an endorsement by fuller exchange liberalization that would have positive effects on domestic and foreign expectations. It would also make it more difficult to adopt macroeconomic policies differing sharply from those of the other industrial countries.

In a perspective extending to Italy's membership of the EEC, the present phase of Community economic policy is marked by extremely important reasons for speeding up Italy's international financial integration and making it more symmetrical. The EEC's basic objective is to create a European market for goods, services and factors of production by 1992. In this context a coordinated programme for the liberalization of capital movements was launched a few months ago, together with a well-defined timetable.

It would be difficult for Italy to oppose these Community policies, which are now agreed on by all the main member countries, including France, with the firm intention of implementing them. Even in a national perspective, there is a strong case for scaling down protectionism, and by doing so now Italy would gain the advantage of enhancing its bargaining power in European economic policy-making and in the advance towards economic and monetary union.

It might be asked whether the objective of greater financial integration, to be achieved by means of exchange liberalization, is not somewhat ill-timed, when authoritative observers in international finance are expressing fears that the deregulation/innovation/liberalization process may have been carried beyond the limits of safety, and it is being suggested in theoretical discussions that the time may

have come to throw a little sand into the mechanisms of the exchange markets in order to reduce international capital mobility.

These are signs of concern that deserve to be carefully examined, although countries have not yet translated them into actual measures implying a reversal of the strategy pursued in recent years. It should, however, be observed that the special situation of the Italian financial system, and of the French one, appears to offer scope for greater liberalization in a specific double sense — the elimination of the remaining administrative constraints on the allocation of financial resources in the domestic market and the abolition of exchange controls — without incurring the risks discussed above.

As to the first cause for concern, it should be emphasized that a liberalization policy of this kind by no means implies indifference to the protection of depositors, the liquidity and solvency of banks or the transparency of financial intermediaries and markets (indeed the controls can, and in some cases, should be intensified). The process only involves the dismantling of the most restrictive direct controls on banking and financial markets and of the constraints that usually privilege the financing of the public sector and prevent the formation of a European financial market.

As regards the second preoccupation, it is hardly necessary to point to the profound difference between the limited friction, such as the one per cent tax proposed by James Tobin, intended to attenuate both inward and outward capital mobility, and a complete set of asymmetrical restrictions on all transactions in the exchange market, designed to discourage the outflow of capital, while inflows are left free and often encouraged.

3.3. - The diversified nature of the objective: components of financial integration

In order to translate the aim of achieving greater international financial integration into operational terms, it needs to be remembered that such integration is composed of several factors and that, in turn, it forms part of a wider financial strategy.

If international financial integration is to be carried out in full, progress will have to be made in each of its constituent parts: the liberalization of capital movements, the liberalization of financial services, and a certain harmonization of the conditions — especially regarding the fiscal treatment of financial assets — that influence the allocation of financial resources.

Here, we propose to devote particular attention to exchange liberalization, in the sense of liberalization of capital movements, since this is the aspect most closely connected to the central theme of the Report. But we must always be aware of the relations linking this factor to the other two components of financial integration.

In turn, financial integration is part of a triad that has been a feature of European countries' financial policies in recent years: the liberalization of domestic financial systems, financial integration and monetary integration. The three factors are interdependent and it is especially important to bear in mind the relationships between financial integration and each of the other two.

3.3.1. - *Financial integration and the liberalization of domestic financial systems*

These two factors stand in a complementary relationship, both as regards desirability and feasibility. On the one hand, there would be no reason for regarding a high level of international integration between financial markets as desirable if the allocation within each of them was mainly determined by administrative constraints. On the other, the gradual elimination of domestic constraints means that interest rates are increasingly determined by the market and creates the conditions for their being more closely aligned with international ones, as Italy's experience in recent years has shown.

There may, however, also be relationships of substitutability. Some domestic constraints give rise, in the same way as restrictions on the outflow of capital, to easier financing conditions for the public sector (a greater supply of domestic funds for any given rate of interest). If the public sector cannot or does not want to renounce a given amount of such support, the problem will arise of choosing between one or the other form of liberalization.

These interdependencies between financial integration and the liberalization of domestic financial systems must be borne in mind in identifying the right public debt policy to accompany exchange liberalization.

3.3.2. - *Financial integration and monetary integration*

These two terms are also linked by relationships of complementarity and substitutability. The former, because both factors are necessary for a real economic and monetary union; the latter, however, arise when the retention of fixed rates of exchange (or rates kept within narrow margins of fluctuation) calls for the introduction or the preservation of restraints on capital movements.

3.4. - THE DIVERSIFIED USE OF THE INSTRUMENT: WHAT EXCHANGE CONTROLS ARE TO BE LIBERALIZED AND HOW

A policy aimed at achieving exchange liberalization, seen as an instrument for securing greater international financial integration, must proceed from the study of the restrictions in force and of the revisions under way, in order to identify those which are to be modified and how. Adequate attention must also be paid to the timetable of implementing measures and to those of a supporting nature.

This is not the place for a searching examination of the operational approach to exchange liberalization measures. Here it will be sufficient to sketch the general lines.

3.4.1. - *The framework of present restrictions*

The restrictions at present in force form a complex set of constraints that is the result of stratifications created over time, and it is not easy to grasp the way in which they are interrelated.

A distinction can be made on the basis of the economic agents directly affected: enterprises, households and financial intermediaries.

3.4.2. - *The present trends in liberalization*

On the legislative plane, particular importance attaches to Law 599/1986, which empowers the government to revise the whole of the current exchange control legislation in the light of the principle that "everything is permitted except what is expressly forbidden". In the light of this principle, and of the still operative one of a national

monopoly of exchange transactions, delegated decrees are being prepared. At the end of January a draft was published by the Ministry of Foreign Trade.

As the report accompanying this draft explains, the measures provide for a gradual liberalization of foreign exchange operations, for their being carried out through banks, for advance determination of the instruments for any exchange policy intervention, for restrictions to be of a temporary nature as well as specifying the procedures for their introduction. The said report also specifies that the draft "only contains the instruments for the application of exchange control policy, and not exchange policy itself. That will be established within the institutional framework laid down by the decree, with choices being combined in accordance with the economic situation at the time".

The perspective adopted here is somewhat different, since it is concerned with the substance of the policy of exchange control liberalization and its linkage with the other aspects of the financial policy put forward in the Report, and not with the identification of the necessary instruments in juridical terms.

The enabling law retains certain features, such as the state foreign exchange monopoly and penal sanctions for exchange control offences, that are not usually met with in the industrially and financially more advanced countries. It nonetheless allows the basic aspects of exchange control reform to be pursued in line with the policy of liberalization set out here. However, the spirit of the draft implementing decree seems to be at least potentially restrictive, particularly in three respects:

a) the different treatment reserved for capital movements as opposed to current operations: the former are subject to restrictions by ministerial decree and the latter only by law. This is a distinction introduced in the draft decree, since the enabling law lays down the principle of "fredom in economic and financial relations with foreign countries" (Article 1/a) and provides no principle or guideline distinguishing between current operations and capital movements (the only indications of specific operations concern trade intermediation fees (Article 1/a) and trade in gold bullion (Article 1/e)). This choice stems from a tradition firmly rooted in Italy and other countries in the last few decades, but is in contrast with the choices actually made by the main industrial countries in recent years.

b) the range of public interests that could be invoked to justify the introduction of restrictive measures. According to the draft decree,

it is enough for the exchange controls to be "designed to achieve monetary policy objectives and counter behaviour causing or liable to cause disequilibria in the balance of payments" (a still broader formula than that of the enabling law, which, *à propos* of the balance of payments, envisages restrictions "to counter effects harmful for the equilibrium of the balance of payments"). It certainly would appear desirable to reserve adequate discretion for foreign exchange policy, but it does not seem appropriate — for the purpose of maintaining a line of steady exchange liberalization — that the regulations should require the competent authorities to provide so little proof of the need for restrictions as to be equivalent to affirming that these can be imposed "whenever the authorities deem it to be advisable".

The Committee considers it desirable that the reference to the needs of monetary policy be made more consistent with the declaration of the Italian Government recorded in the minutes of the ECOFIN meeting of 17 November 1986, which envisages the development of instruments and procedures exclusively for the purpose of countering destabilizing capital flows.

c) The restrictive interventions foreseen, with particular reference to those in the field of capital movements, where the draft decree provides for non-interest-bearing deposits and a two-tier exchange market.

The Committee takes a less favourable view of the adoption of any such measures, as specified below.

3.4.3. - *Guidelines for further liberalization*

If full exchange liberalization is to be achieved, the review of exchange control legislation in the future will have to extend beyond specific changes in the matters that are currently regulated and seek to overcome the limits that, though less onerous, the reform being enacted under the enabling law will leave in place.

With this in mind, and drawing on experience and developments in a broader context, the Committee has formulated a set of guidelines that appear to deserve special attention.

3.4.3.1. - *The application of the EEC Directives*

The main point of reference is provided by the policies adopted by the EEC, with Italy's full support, and in particular by the White Paper on completing the internal market and the programme for the liberalization of capital movements, both scheduled for implementation by 1992.

As regards the liberalization of capital movements, the Community authorities recognized in May 1986 that the achievement of the objective presupposed complete freedom not only for capital movements linked to the exercise of the other basic freedoms of the common market (free movement of goods, services and persons and freedom of establishment) but also for operations in financial securities and, lastly, for financial loans and money market instruments.

The scale of this plan means, as the EEC Commission recognized, that it has to be carried out in two stages. In the first, the unconditional and effective liberalization of the operations needed for the proper functioning of the common market and for the linking up of national securities markets implies a transition to a regime of unconditional liberalization of the related transactions, as well as the elimination of all the derogations under the safeguard clause of Article 108 of the Treaty of Rome. In the second stage, the creation of a capital market without internal frontiers implies the suppression of all the restrictions in force on financial loans, money market operations, deposits and current account balances.

Pursuant to the application of this liberalization programme, and in particular in order to realize the objectives of the first phase, in June 1986 the ECC Commission submitted a proposed directive to the Council with a "third amendment to the first Directive for the application of Article 67 of the EEC Treaty".

The aim of the Directive, which was approved in November of the same year, is to permit the full liberalization of the operations needed to complete the internal market and link up the financial markets in the community. Technically, the Directive provides for certain operations that the first directive subjected to the discretion of member states (list C) to be completely liberalized and included in list A. These operations comprise:

a) long-term commercial loans connected with commercial transactions or to the provision of services in which a resident takes part. Complete freedom, which previously applied only to short and

medium-term loans, was extended to long-term ones related to the free movement of goods and services;

b) the purchase by residents (non-residents) of foreign (national) securities. The obligations in force under Community law formerly applied only to securities traded on a stock exchange, and excluded the purchase of investment fund units and of foreign bonds issued on a foreign market and denominated in national currency. The new measure extends the liberalization to all medium and long-term securities, whether traded on a stock exchange or not.

c) The admission of securities to the capital market. The Community law previously in force included the issue and placement of securities in the discretionary area (list C). The new measure is designed both to remove the obstacle constituted by the discretionary regime and to permit the listing in the capital market of another member state of shares and bonds traded on a stock exchange or for exchange or for which an application for listing has been made, as well as of the units of investment funds as set out in EEC Directive 65/611.

Italy's exchange controls in this field have been brought into line with Community policy by the Ministerial Decree of 12 February 1987. Since the operations of point *b)* above are similar to others for which Italy was allowed to invoke the safeguard clause, the EEC Commission has authorized their being subject to the non-interest-bearing deposit scheme until the end of 1987.

3.4.3.2. - *The internationalization of the lira*

Together with other restrictive measures, steps were taken in 1976 to block every possible channel for supplying foreign markets with liquidity in lire:

a) the ban on the granting to non-residents of facilities in "external account" lire and on making deposits in lire with foreign banks;

b) the ban on overdrafts on external accounts in lire held by non-residents;

c) the introduction of penalties on overdrafts resulting from non-compliance on the part of holders of external accounts;

d) the ban on operations within the "spot-against-forward" ceiling in the form of transactions in lire with non-residents.

The instruments adopted combined with the downward trend of the nominal exchange rate of the lira to prevent Italy's currency from taking its place in international markets, thus leading to a sharp fall in the use of the lira for the settlement of foreign transactions and hence its gradual emargination from the international payments system.

For some time now there has been a change in official policy towards the lira. Examples of this include the monetary authorities' encouragement of the creation of a Eurolira bond market reserved for foreign residents. This new financial instrument should make it possible both to satisfy the requirements of foreign issuers who wish to invest medium-term in lire and, more generally, to promote the internationalization of the lira.

Other recent administrative measures fit into this new perspective. The Ministry of Foreign Trade has granted special authorizations for some banks to provide lines of credit in lire to some countries to pay for imports from Italy; and banks have been allowed to make advances in lire to foreign banks repayable in ten days, provided these amounts are used to make payments to Italian exporters.

These measures are designed to achieve a partial extension of the external use of the lira. They prompt the Committee to suggest a coordinated plan for the internationalization of Italy's currency, with the restraints on its international use being removed one by one.

3.4.3.3. - *The management of firms' foreign currency resources*

The scope available to firms for managing their foreign currency resources is strictly limited. The exchange purchased and received by operators must flow into foreign exchange accounts and be used within the time allowed, forward purchases and sales of foreign currency must be closely related to a clearly defined commercial transaction, foreign currency financing can be obtained from duly authorized banks only if linked to specific operations involving imports, exports or the supply of services.

This situation certainly does not make it easy for firms to achieve an optimal financial situation. Better management of foreign currency resources, more appropriate hedging of exchange risks and wider access

to finance are some of the imperatives to be satisfied if firms are to achieve stable profitability.

Accordingly, the Committee believes certain exchange controls should be removed in order to:

a) enable firms to use a single (centralized) external account for all the foreign currency resources of their subsidiary and related companies. This would permit firms to optimize the management of foreign currency resources at the group level;

b) decouple once and for all forward transactions from the specific underlying operations. In brief, firms should be allowed to make forward contracts in foreign exchange with ceilings to be defined on the basis of objective parameters, regardless, in other words, of the existence of clearly identified operations. In this way, it will be possible to hedge exchange risks in advance of the stipulation of the contract for the underlying operation;

c) permit a wider and more efficient use of the instruments for hedging exchange risks — e.g. foreign currency options. In easing the present restraints, which make it hard and relatively expensive to negotiate options in lire, it would be advisable to do away with the rigid links with the underlying commercial operations and permit the resale of such options in the secondary market. This might make it more advantageous for firms to use this instrument, as well as making it possible to pursue more diversified and flexible strategies for managing exchange risk;

d) allow operators access to foreign currency financing in relation to their overall needs. In other words, not only specific operations should be financed but operators. This approach is gaining ground. At present the competent authorities accept without difficulty requests for such financing from operators in specific sectors. For example, there are measures that enable exporters to obtain foreign currency financing from Italian banks up to 50 per cent of their previous year's turnover.

3.4.4. - *Some operational questions*

The non-interest-bearing deposit should be eliminated by no later than the end of 1987, by when the last EEC Directive will have come fully into force in Italy too. This timetable implies an intense drive towards exchange liberalization in the space of a few months.

There are, of course, a number of operational problems regarding the way in which the imminent liberalization should be implemented. The following are some of the most important points:

a) whether, for the operations that are about to be liberalized it should remain obligatory for operators to carry them out through an authorized bank and for the operations to be reported to the Italian Foreign Exchange Office (UIC).

The Committee feels able to give a positive reply to this first question since the intervention of an authorized bank provides a guarantee that the tax regulations regarding income from foreign investments will be observed. It also provides a data base for statistics on the various types of operation.

b) Whether permission to purchase foreign assets should be confined to those which — even though subject to the non-interest-bearing deposit — can already be purchased (*i.e.* securities and real estate) or whether it ought to be extended to all assets, or at any rate to a broader range than at present, including bank deposits in particular.

The Committee considers that a prudent solution might consist in aligning the liberalization process with the EEC programme for capital movements.

Since this makes it possible to put off the liberalization of monetary instruments to a later stage (than that scheduled for 1987), Italy could well postpone granting the right to hold bank deposits abroad in view of their high liquidity. However, since it is practically impossible to manage portfolios of foreign securities without moving foreign currencies through bank accounts, in the interim between the abolition of the non-interest-bearing deposit and the liberalization of bank deposits residents should be allowed to hold foreign currency "service" accounts with Italian banks, subject to suitable restrictions.

c) The kind of tax system to be applied to foreign assets.

The Committee feels that once exchange controls have been entirely eliminated, the fiscal treatment of financial assets ought to avoid discrimination between domestic and foreign assets.

Freedom to operate on international financial markets ought not to be hampered by tax discrimination against certain operators, as is the case at present for the interest paid by Italian residents on securities issued abroad. Whereas the income earned on government securities or their equivalent issued abroad is still exempt from tax, even after

Decree Law 556/1986, the interest, premiums and other income from bonds and similar securities paid abroad by any resident, therefore including banks, are normally subject to a withholding tax at a rate of 12.5 per cent.

This encourages banks to resort to the interbank market, since the interest paid by Italian banks to banks established abroad is exempt from the withholding tax. Not only is this form of fund-raising generally more costly, and sometimes amounts to a means of circumventing regulations, but the heavier taxation of the funds obtained through bond issues tends to exclude Italian banks from the Eurobond market and from foreign bond markets as well. It would therefore appear desirable to exempt the income from securities issued abroad by Italian residents, or at any rate Italian banks, from the withholding tax.

3.5. - The timing of exchange control liberalization

As discussed above, the timing of parts of the exchange liberalization process in Italy is dictated by EEC rules. For technical, juridical and political reasons it appears neither expedient nor easy for Italy not to comply.

This nonetheless leaves some room for flexibility in respect both of the timing envisaged by the EEC (in the sense that the liberalization measures required could be carried out ahead of time) and of the possible liberalization of some aspects not covered by the Community provisions.

With reference solely to the aspects of the liberalization process allowing some flexibility, there are two possible courses: a single, big-bang type switch to complete exchange freedom or a gradual transition.

Considering the long period for which exchange controls have been in force, the backlog of desired portfolio adjustments in terms of foreign currency composition, the size of the budget deficit and the growth of the public debt, the Committee recommends a gradual but reasonably rapid transition along the lines indicated above.

There are grounds for believing that the Italian economy is in a position to sustain an extensive exchange liberalization. The possibility of net outflows of funds cannot be ruled out, but the danger of these swelling to huge proportions seems less than in earlier periods. Real interest rates are no longer lower than international ones as they were

over long periods in the past; nor are the rates of return on shares and direct investments any lower than those obtainable in foreign markets. Confidence in the general state of the Italian economy appears high both in Italy and even more outside, while the pronounced volatility of exchange rates increases the risk of investing in foreign currencies compared with the days of fixed exchange rates.

Should net outflows of capital occur, they could be compensated to some extent by private and public sector operators issuing of liabilities abroad, in line with the increase in the foreign assets of households and enterprises.

Within certain limits net outflows in excess of compensatory inflows following liberalization would be possible without generating tensions in a period in which the current account of the balance of payments is expected to be in a much healthier state than in the seventies, when the various exchange restrictions were introduced or tightened.

There might be difficulties in financing the public sector or renewing the debt falling due. However, this problem needs to be distinguished from that of the balance of payments; it would signal that, even with interest rates aligned with those abroad, exchange restrictions had still provided help in financing the public sector. This situation could be overcome not only by an appropriate strengthening of the programmes for curbing the budget deficit net of interest payments but also by suitable debt management measures (see Section 6).

The Committee feels that the step-by-step approach in the adoption of liberalization ought to be applied without practising further discrimination against individual savers as compared with firms or savers who turn to investment funds. In fact, what is needed is a system based on recognition of the right to allocate savings between different currencies.

3.6. - Supporting measures

The exchange liberalization policy recommended here needs to be backed by a certain number of supporting measures.

The fundamental aspect, which in the long run can be regarded as an essential precondition for the creation of a sustainable regime of financial integration and freedom of capital movements is naturally the completion of Italy's macroeconomic adjustment. In this context, particular importance attaches to the restoration of the public finances to a sound footing, which in effect means curbing the public sector

borrowing requirement net of interest payments. Should it not be possible to achieve the targets for the medium-term control of public finances indicated by the Minister of the Treasury and discussed in Section 2, the effects, if not the actual feasibility, of exchange liberalization would inevitably be jeopardized.

Other measures must also be considered:

Still à propos *of public finances, the Committee sees the transition to a financially open economy as requiring, in view of the high level of the public debt, changes in the techniques used for the management of the latter.*

These should include:

a) a widening of the range of securities offered by the various issuing agencies with a view to exploiting the market demand for diversification and creating, at no extra cost to the issuer, a larger demand for securities capable of offsetting any future decline in demand due to the attractiveness of foreign assets. In this context, there appears to be some validity in the arguments for the Treasury having recourse to price-indexed long-term securities, both because of the probable reduction in the real cost of financing connected with the elimination of the inflation-risk premium and because the cost of such instruments would be less sensitive (than that of Treasury bills and credit certificates) to movements in short-term interest rates, which are subject to wider fluctuations when capital movements are free;

b) better issuing techniques, such as greater recourse to auctions, again with the aim of making issues more "efficient" in terms of quantity at a given rate, as is desirable for a Treasury operating in a market that exchange liberalization will have made more competitive;

c) regular issues of securities abroad, thus extending, in the light of any needs caused by the exchange liberalization policy, a practice for which there are several precedents in recent years.

An additional supporting policy concerns the exchange rate. The Committee considers that it would be advisable, especially during the liberalization phase, to retain the lira's present 6 per cent fluctuation band in the EMS.

This would make it possible during the transition to freedom of capital movements to mitigate the fluctuations in short-term domestic interest rates that portfolio adjustments might generate. This possibility is especially important in view of the sensitivity of the average total cost

of the Italian public debt to short-term rates (due to the large share of Treasury bills and credit certificates in the total).

There is also the question of possible temporary safeguard measures to be invoked if turbulence is feared or actually develops during the transition to greater exchange freedom. The hypothesis has also been vented of recourse to a two-tier exchange market. This, however, is difficult to administer for any time and is explicitly mentioned in the EEC programme for freedom of capital movements as an obstacle to be eliminated where it is permanently in force (Belgium and Luxembourg) and which may be justified provided it replaces every other restriction on capital movements.

Still on the question of exchange markets, the Committee is of the view that it is also necessary to introduce a policy for intervention in the forward exchange market in view of the requirements of monetary policy.

Other measures to back liberalization would have to be negotiated within the framework of the EEC.

One of these, the Committee believes, is the reorganization of the EEC's own financial instruments.

Accordingly, it would be useful to increase the available funds and redefine the cases in which countries can have access to them, explicitly indicating "capital outflows" as a valid ground. It would be necessary, however, to use such financing to meet needs arising from the transition to freedom of exchange operations (which is a structural advancement that may entail the outflow of funds in connection with portfolio adjustments), but using great caution when the outflows are due to differences in relative costs and prices and should be corrected rather than financed.

Another subject for fundamental negotiation, the importance of which — in the opinion of the Committee — goes beyond exchange liberalization is that of a definition of EEC economic and monetary policy.

It is particularly important that this subject should be thoroughly studied and clarified, especially by the strong currency countries, so that those taking the step of liberalizing their exchange controls and thereby increasing their integration into the system, will have a better understanding of the macroeconomic model for the management of the Community economy as a whole and be able to cooperate in establishing the parameters. Conversely, the pressure for such a clarification might be greater if the countries seeking it were to show their willingness to adhere to the rules of the EEC game by removing their own obstacles to the creation of an integrated financial market.

Section 4. - The stock exchange and share market policy

4.1. - The stock exchange and the circulation of financial wealth

A complete analysis of the financial system should include a thorough study of the problems concerning stock exchanges, especially in view of the important role they play, albeit with wide differences from country to country, in the transfer of the ownership and control of enterprises, as well as in their financing through issues of both shares and bonds.

The public's portfolio choices, particularly as regards diversification between shares and other financial assets, between government securities and corporate paper and between domestic and foreign securities, can only be made efficiently with a stock exchange that works properly.

The forces brought into play by the liberalization of capital movements and the supply of financial services accentuate the need to increase the efficiency of the capital markets and in particular that of the stock exchange. In the first place, this will mean reducing transaction costs in the broad sense of the term, both to avoid discouraging inflows of foreign capital that could help to offset any outflows associated with the liberalization programme and to ensure that this component of the Italian financial system is internationally competitive.

Finally, the share market appears to be acquiring an increasingly important role in the transmission of monetary policy, not only because the latter is increasingly focusing on markets rather than intermediaries but also because of the growing share of equity-financed rather than loan-financed investment and the wealth effects associated with the rise in the proportion of households' financial assets held in the form of shares.

The following analysis will concentrate on describing and formulating proposals for the aspects of the stock exchange that appear to impinge most directly on the basic themes the Committee is required to examine.

4.2. - The inadequacy of supply in the share market

The development of the share market has been primarily due to the improvement in the profitability of listed companies and to an increase

in demand. By contrast, there has not been an adequate increase in the supply of shares by way of flotations. Two figures are sufficient to bring this out clearly. Even though 1986 saw the listing of 42 new companies on the Milan stock exchange (13 in 1985), the total number of listed companies at the end of the year (186) fell far short of the corresponding figures for the leading stock exchanges abroad.

In a sense, moreover, the figure for new listings is overstated since very few of the companies coming to the market did not belong to a group with other companies already listed. At the end of 1986 only 24 per cent of the total market capitalization was attributable to companies that did not belong to the four leading private groups and the public sector.

Another telling figure can be deduced from the latest Mediobanca survey of Italian firms — only twenty or so of the 100 largest Italian firms in terms of turnover are listed on the stock exchange, even though many others have all the requisites for listing.

4.2.1. - *The advantages and costs of a listing*

It is difficult to determine and assess all the various reasons that discourage Italian firms from seeking a stock exchange listing and from raising equity capital by this route.

The advantages of a listing are well known: the prestige and enhanced bargaining power it brings make fund-raising easier; the realizability of shareholders' investments is enhanced; shareholder controllers are able to realize the value of goodwill in the market and maintain control by issuing savings shares.

The direct costs incurred at various levels in connection with a listing are related to the obligations it entails:

a) for the company: the cost of supplying additional information, both to the market and, more importantly, to the public supervisory body (consolidated and audited accounts, half-yearly reports and details of investments in other companies, etc);

b) for directors, statutory auditors and general managers: the obligation to provide the public supervisory body with information on their interests in their company and its subsidiaries as well as on their remuneration;

c) for shareholders: the obligation to inform the public supervisory body of their interests in the company above a certain percentage of its issued capital.

The Committee is of the opinion that these are minimum requirements if the market is to be adequately transparent even though they may still represent an impediment to the flotation of new companies.

In addition to these obvious advantages and costs, there are other, more strictly economic factors that are difficult to assess. Thus, analyses are not available that would permit the cost of share capital in Italy to be compared with that of loan capital. It is worth noting, however, that the laws designed to promote development in Italy have always made it more advantageous to have recourse to the latter.

4.2.2. - *Incentives to seek a listing*

The question is whether it would be desirable, or practicable, for the authorities to intervene to encourage the growth of the share market, especially in terms of the number of listed companies. Feasible measures could focus primarily on the side of the demand for securities or on that of their supply, though in either case the result would be a reduction in the cost of funds so that both the demand and the supply would be affected.

The most common interventions are of a fiscal nature. On the demand side there can be either blanket measures or selective relief for stock exchange investments, such as those provided by the Monory Law in France. On the supply side there can be exemptions from the tax on the capital gains that companies realize when they first listed their "offspring". Thus, until 31 December 1985 Law 169/1983 in Italy exempted companies from the tax on capital gains arising from the disposal of shares in connection with the listing of subsidiaries.

As regards the possibility of prorogating Law 169/1983, this cannot be in addition but only in alternative to the provisions of the recently approved government bill on the revaluation of firms' assets with a 75 per cent reduction in the corporate income tax liability in respect of such revaluations. Even though they are not aimed specifically at the problem of stock exchange listing, the government's proposals will certainly permit a considerable reduction in the cost of obtaining a listing in the period in which they will be in effect.

The Committee does not intend to propose tax relief on the demand side insofar as it does not take a favourable view of further exceptions being made to the existing tax system. Rather, it is of the opinion that it would be desirable to reduce the disparities in the tax treatment of different financial assets since these can also affect transaction costs.

4.2.3. - *The abolition of registration: the fiscal aspects*

Accordingly, the Committee examined the problem of the costs and benefits that could arise from the abolition of the compulsory registration of shares. In view both of the reluctance, particularly pronounced in Italy, of investors to hold registered securities, and of the increase in transaction costs that registration entails, the benefits for the market are evident.

It is notable that in some cases shareholders actually renounce their dividends in order to avoid having to declare their holdings in their income tax returns. This can give rise to distortions in stock exchange prices when dividends are declared and paid. It also encourages firms to limit the dividends they distribute and enhance the prospect of capital gains, in the short- as well as the long-term, a technique often used for the shares of newly listed companies.

The abolition of compulsory registration would generate costs on two scores: in the field of tax revenues and that of civil law and public supervision.

The Committee is of the view that compulsory registration cannot be justified at the present time on tax grounds.

In principle:

a) Article 82 of the codified law on direct taxes exempts, for all practical purposes, capital gains realized as a result of the sale of shares from progressive personal income tax (IRPEF). This accentuates the advantage of receiving the rewards of shareholding in the form of capital gains by permitting income tax to be avoided;

b) the assessment of the dividends received by shareholders for income tax does not necessarily require shares to be registered, but can be carried out in other ways.

In practice, the scope for avoiding or evading both personal income tax and death duties is considerable and it is fully exploited, particularly in the case of large holdings, so that the tax tends to be regressive in its effects.

Overall, revenues might actually increase if the dividend tax were replaced by the possibility of choosing between a sufficiently high flat-rate withholding tax in settlement of income tax liabilities (*e.g.*, 30 per cent) and including dividends in investors' income subject to progressive taxation, with some form of tax credit being maintained. In practice, the cost of anonymity would be a degree of double taxation. Since at least some shareholders pay the current price of anonymity by renouncing their dividends, the proposed system would allow a part of the tax base to be recovered and an increase in the effective rate of taxation. There would therefore not only be no loss of revenue to set against the reduction in transaction costs, but there would probably be a decrease in fund-raising costs and an incentive for shareholders to take a more active interest in their companies.

4.2.4. - *The abolition of registration: the civil law aspects*

The abolition of registration also raises issues with respect to company law and the public control of companies and the share market.

As regards the former, such a step would not require a global reform since the Civil Code provides that the shareholders of public limited companies shall be free (except in some special cases) to choose between bearer and registered shares (Article 2355). Accordingly, all the other provisions of company law are drafted in such a way as to be applicable regardless of the form in which shares circulate. Consequently, even if the provisions requiring, in conformity with Article 109 of the rules for the application of the Civil Code, registration were repealed, the resulting system would be determined and perfectly consistent.

In this connection it is worth noting that the reintroduction of bearer shares (the savings shares covered by Article 14 of Law 216/1974) did not create any particular problems in civil law regarding their compatibility with the compulsory registration of ordinary shares.

4.2.5. - *The abolition of registration: the administration of controls*

The issues raised with regard to the public control of companies and the share market are more difficult. The regulations governing this matter contained in Law 216/1974 and the subsequent amendments

reflect the more than forty years of experience with a system based on the compulsory registration of shares. Evidence of this is the reference in the Law, and in numerous regulations issued by the CONSOB, to company share registers as providing information for the identification of the shareholders of companies subject to control. The principal use made of company registers is currently for the purpose of distributing dividends and controlling attendance at shareholders' meetings.

Parliament appears to have taken this into account when it drafted Article 5 of Law 216/1974, one of the provisions of which requires any shareholder with more than 2 per cent of the issued capital of a listed company to inform the CONSOB and the company itself, regardless of the updating of the company share register. Furthermore, Article 4 (b) of the same Law lays down that listed companies (and corporate shareholders) required by the CONSOB to provide the names of members shall have regard not only to the share register but also to any notifications received under Article 5 and any other relevant information in their possession.

The linchpin of the system designed to ensure the transparency of corporate ownership is the mechanism foreseen by Article 5 of Law 216/1974 for listed companies (and the analogous Article 9 of Law 281/1985 for companies engaged in banking business). Article 5 makes no provision for shares to be registered, so that the mechanism would be perfectly viable even if the rule making registration compulsory were to be repealed.

It might be objected that the absence of endorsement in share transfers following the abolition of compulsory registration would deprive the supervisory body of a useful way of monitoring the observance of the requirement to notify shareholdings of over 2 per cent of issued capital (article 5 of Law 216/1974). In practice, however, the scope for such controls is hypothetical and has only been exploited on a very few occasions.

In short, the abolition of compulsory registration would make it necessary to adjust both the primary and the secondary legislation governing the public control of corporate ownerships and the share market, especially as regards the provisions relating to the identification of the shareholders of companies subject to control by the CONSOB, but it would not require a radical recasting of the present legislation. In practice, the new arrangements would not significantly modify the powers of control over share ownership. They might, however, make it easier to avoid controls, insofar as persons wishing to conceal their

identity by failing to make the prescribed notifications would be able to do so without having to employ any special devices (registration in the names of nominees and foreign companies, etc.) to make control impossible or extremely complicated.

Besides, the CONSOB would still be able to discover the existence of controlling, or at any rate significant, holdings when extraordinary shareholders' meetings are held and when the accounts for the year are approved. In addition, if it was considered desirable to provide companies with another means of identifying their shareholders, it would be sufficient to provide for the information gathered for tax purposes when dividends are paid to be communicated to the company, a procedure that is already foreseen by the regulations governing Monte Titoli (Article 9 of Law 289/1986).

The abolition of registration could be restricted to listed companies, with the shares of other companies continuing to be registered. The circulation of shares in bearer form is convenient for companies with a large shareholder base; it could therefore be a "privilege" that would help to offset the costs, particularly in respect of information, that listing involves and thus serve as an incentive to seek listing. It would be possible, of course, to make exceptions to the general rule by requiring, for example, that the shares in listed banking and publishing companies should remain registered in view of the considerable public interest in such companies.

Although the Committee considers that the main issues arising from the abolition of the registration of shares in listed companies concern the methods and scope of controls, it recommends that the public interest in company affairs should be protected by legislation that would regulate groups and promote competition, rather than by imposing registration, which is easily circumvented, especially at a time when capital movements are being liberalized.

4.3. - The working of the share market

Without pretending to be complete, the following is a list of the main problems affecting the securities market in Italy: the definition of the requirements for stock exchange listing; the supply of information in connection with initial flotations; the pricing of initial flotations; the physical circulation of traded shares; the real significance of official prices, bearing in mind how they are formed and the existence of

parallel markets with in-house matching of orders; the various types of market; and the regulation of market operators.

Some of these problems, and specifically the last mentioned, are beyond the scope of the Committee's mandate and are being reviewed by other bodies. Accordingly, they will not be considered here.

4.3.1. - *Listing requirements*

As regards the first problem, it should be noted that the rules issued by the CONSOB (within the limits laid down by Presidential Decree 138/1975) defining the requirements for listing (minimum capital, distribution of shares among the public, net profit in each of the three preceding years and audited accounts) do not appear sufficient to prevent certain distortions.

For example, the rules do no exclude the listing of companies that are too small for a meaningful market to develop in their shares. They also fail to overcome the problem of "captive" companies or, in other words, of companies whose activity is subordinated, in operational and/or financial terms, to the activity of companies belonging to or controlling the group. In such cases, of which the Italian stock exchange actually offers very few examples, conflicts of interest can arise between controlling and controlled companies to the detriment of shareholders.

The Committee is of the opinion that a ban should be placed in principle on the listing of companies whose activity in raising working and/or investment capital or whose income-earning activity is subordinated to that of a controlling company or of a company of which the group owns more than 50% or at any rate a controlling interest.

The foregoing case needs to be distinguished from that of the listing of companies controlled by a holding company that is already listed (the so-called Chinese box conundrum). The decision to invest in a parent company or in a subsidiary is often equivalent to choosing between the shares of an operating company and those of a closed-end investment fund serving a specified purpose.

The important point for present purposes is that Chinese boxes can be used to circumvent obligations laid down by statute or administrative law (for example, the relationships between ordinary shares, savings shares and bonds). To overcome this drawback, the Committee is of the opinion that special provisions governing corporate groups will be necessary and recommends their enactment.

4.3.2. - *The supply of information to the market*

As regards the information to be supplied to the market in connection with issues of securities, Law 77/1983 extended the requirement for companies to submit a prospectus when making public offers for sale to satisfy stock exchange listing requirements in terms of shares held by the public. Prospectuses have undoubtedly undergone considerable development since their adoption, but further progress remains to be made and specific legal provisions have to be introduced to enhance their meaningfulness and clarity.

4.3.3. - *The pricing of initial flotations*

By contrast, the problem of pricing flotations and determining their size still appears far from a satisfactory solution. It has two aspects: a short-term one concerning the difference between the issue price and the initial quotation in the aftermarket; a longer-term one concerning the relationship between the issue price and the expected and actual profitability of the company.

Recent experience on the Italian stock exchange was initially marked by a predominance of issues that were underpriced in the short term and subsequently by an increase in the number of cases of long-term overpricing.

The short-term aspect depends to a large extent on how and when issues are placed. The time that elapses between the fixing of the issue price and the start of placing operations is undoubtedly too long. The numerous legal requirements with which issuing companies have to comply and the related delays often result in market conditions having changed considerably by the time operations are completed. The length of these delays makes fixed price flotation by way of a consortium unsatisfactory, though they are used much more frequently than offers for sale by tender.

In general, and notwithstanding some sectoral variation, the standard ratios (price/earnings, price/cash flow and price/shareholders' equity) have always been much lower for new issues than for listed shares. This fuelled expectations, nearly always fulfilled, of large differences between the fixed issue price and that recorded in the first few days of trading in the aftermarket. In turn, this led to considerable excess demand for new issues and to the adoption of allotment systems

that on occasion were anything but easily comprehensible and which led to doubts about the behaviour of the members of placement consortia.

Offers for sale by tender obviously avoid some of these problems since investors' expectations with respect to prices in the aftermarket are reflected in the price they are prepared to pay. Indeed, when initial flotations have been made by tender, the striking price has initially remained stable in the aftermarket.

The longer term aspect emerges in the premium that the issuing company fixes with respect to the face value of its shares. The differences between issue prices and initial quotations in the aftermarket, together with the widening gap between the market capitalization of listed companies and the face value of their issued capital (the ratio between them rose from 2.2 at the end of 1984 to around 6 at the end of 1986), led companies to increase their issue premiums. It is worth noting that the proportion of all the equity capital raised by listed companies attributable to share premiums rose from 5 per cent in 1984 to 50 per cent in 1985 and to nearly 60 per cent in 1986.

The question of excessive premiums came to a head in particular for savings shares because the device threatened to thwart the law designed to ensure that the holders of such shares received preferential treatment in the distribution of profits to offset the restrictions on their other shareholder rights. The discrimination arises because the distribution of dividends is based exclusively on the face value of shares at issue. To overcome this problem, a series of proposals have recently been put forward.

The Committee takes the view that these shortcomings can be remedied by better knowledge about the market coupled with a procedure, if necessary with statutory backing, for the congruity of share premiums to be certified and adequately publicized.

4.3.4. - *The physical circulation of securities*

The difficulties encountered in the physical circulation of shares are specific to the Italian market and the result of a combination of inefficiencies. The failure to remove them discourages foreign investors and appears all the more serious at a time of increasingly unrestricted capital movements since it curbs the potential for capital inflows that will help to offset any resulting outflows.

Law 289/1986 establishing Monte Titoli S.p.A., with which it is intended shares are gradually to be deposited as a preliminary to the switch to a book-entry system, and the subsequent notice issued by the CONSOB simplifying the procedures for the settlement of the transactions of non-residents mark a start to the elimination of these shortcomings of the Italian market.

This contribution, however, is not sufficient on its own. Membership of Monte Titoli is at present optional and there is no guarantee that the desired centralization of shares will actually occur. One obstacle to making membership compulsory is perhaps the monopoly the company enjoys.

An attractive solution in the Committee's view would be to make membership compulsory but to eliminate the monopoly by setting up a small number of other companies to perform the same fuction as Monte Titoli.

4.3.5. - *The significance of stock exchange prices*

A much debated issue is that of the significance of the prices fixed on the stock exchange when, as in Italy, such a large part of trading is off the exchange. The turnover on the 10 Italian stock exchanges amounted to 27 trillion lire in 1985, while the trading of the 50 largest banks totaled 39 trillion (in 1984 the corresponding figures were 8.2 and 12.5 trillion).

The disadvantages inherent in this situation are obvious: the smaller the proportion of trading carried out on the stock exchange, the easier it becomes to manipulate prices with limited resources. The damage this can cause is all the more serious in view of the "official" nature of stock exchange prices and their external importance.

Partly with the aim of eliminating this shortcoming, the CONSOB has recently approved a revision of the trading methods employed on the stock exchange with the replacement of the call-over auction system with a continuous one. It is hoped that this will attract a larger volume of trading to the stock exchange by making the mechanism for fixing bid and offer prices more flexible and trading itself more convenient.

The introduction of this new method of trading should also help to improve the transparency of the market and create the conditions for the creation of market makers, whose interventions should serve to smooth out changes in the prices of listed shares due to temporary and random imbalances between demand and supply.

The planned change can nonetheless do no more than promote the conditions for increased trading on the stock exchange and leaves two problems unsolved:

a) how to convince operators to do all their share trading on the stock exchange; and

b) how to establish special segments in the official, and therefore regulated, market for transactions that do not lend themselves to the auction method.

If the stock market were rationally organized, all operators would prefer to trade by the auction method in the securities that lent themselves to such treatment. The reason why this is not the case in Italy is that the operators who handle the majority of clients and orders (banks and licensed dealers) are not allowed to trade directly on the stock exchange but have to employ stockbrokers, whom they consider superfluous. These operators have expressed their willingness to do all their trading on the stock exchange on condition that they are allowed to operate there directly, a condition that the stockbrokers reject on the grounds that banks and licensed dealers are "multifunctional" operators (*i.e.* also dealers or portfolio managers) and therefore would not be neutral in the price-making process.

To overcome this obstacle, a proposal has been put forward whereby access to the stock exchange would be granted to new broker firms owned jointly by stockbrokers and banks and licensed dealers. The discussion on this matter now appears to be focusing primarily on the problems of the control of such companies (legal form, the type of majority, etc.).

The Committee nonetheless deems it desirable to point out that a solution of this kind would be in the opposite direction to the main stream of developments on leading markets abroad, where the tendency is to remove the barriers between dealers and brokers and to liberalize access to the floor.

4.3.6. - *The various types of markets*

The frequency or the size of certain operations, as well as the special features of the securities involved in others (shares that are unlisted or awaiting listing) and the nature of block trading, will result in such operations continuing to be conducted off the stock exchange in

dealer and/or broker markets. To ensure that these operations are sufficiently transparent, it appears desirable that they should also be carried out in a regulated market.

Notwithstanding the scale of off-market trading in Italy, the growth of the official market has been considerable, with substantial increases not only in turnover but also in the number of shares traded and the ratio of turnover to market capitalization.

This growth in stock exchange business was not paralleled, however, in the second-tier market, where the ratio of turnover to market capitalization was no more than 2 per cent, compared with 27 per cent for the Milan stock exchange and 20, 25 and 100 per cent in the corresponding markets in Paris, London and Amsterdam. The total value of the shares traded in the six Italian second-tier markets amounted to no more than 211 billion lire in 1985 and to about 400 billion in 1986. By contrast, the turnover on the official Milan stock exchange averaged 265 billion lire a day in 1986.

It is therefore hardly surprising that no company should have applied for listing on the second-tier market in either 1985 or 1986, while in this period 5 of the 39 listed companies applied for stock exchange listing.

These figures point to the need for a rethinking of both the role and the structure of the second-tier market in Italy. The options appear to be to make the market into a stepping stone for firms wishing to proceed to a full listing on the stock exchange or to use it for operations involving a size of listed company and type of security that would allow it to play a separate role of its own. The recent decisions taken by the CONSOB tend to enhance the market's stepping stone function by removing the obstacles to its efficient functioning (working hours and days, settlement arrangements, listing requirements, the possibility of delegating the preliminary examinations of listing applications to the reorganized committees overseeing the second-tier markets).

The Committee is of the opinion that the second of the two possibilities outlined above is the more interesting, though they are not mutually exclusive. In particular, there are a great many companies that are not particularly important at the national level but which are of considerable local significance.

Regionally specialized second-tier markets could serve for the listing of such companies. This choice would take on even greater importance if investment funds could be allowed to purchase the shares of leading local companies listed on second-tier markets.

To this end, the Committee recommends that all or part of the investment funds' (currently unutilized) right to invest in unlisted companies within limits should be transformed into the right to invest, again within limits, in shares listed on second-tier markets.

Section 5. - Monetary policy

5.1. - The transformation of monetary policy in Italy

The high and variable rate of inflation in the seventies and early eighties and the large public sector borrowing requirement that persists even today inevitably feature prominently among the forces that have shaped the trends of Italian monetary policy in recent years. Inflation in Italy was fuelled by the two unexpected and massive increases in the price of oil, which exacerbated an already precarious situation caused, in 1973 at any rate, by excessive demand, rising labour costs and budgetary policies geared more towards expanding public services than to covering their cost.

Hence for a large part of the seventies monetary policy was reinforced by exchange controls and direct credit restrictions in an attempt to accommodate the disequilibria, bearing in mind the need to avoid a loss in Italy's share of export trade. This resulted in an exchange rate policy aimed at offsetting inflation differentials *vis-à-vis* Italy's competitors. Membership of the EMS, better control of unit labour costs, the decline in oil prices and a revival of entrepreneurship have made it possible to bring inflation down to a level not seen since the end of the sixties. "Divorcing" the central bank from the Treasury has made control of the money supply easier and the insistence on positive real interest rates from 1982-83 onwards has helped produce and defend the results obtained in the fight against inflation. These developments have led to a switch in monetary policy from direct to indirect control, a reduction in the constraints on banks and businesses, particularly the latter, and exchange rate management more directed towards creating the conditions that would improve productive efficiency.

Further changes will follow in the near future, induced by financial innovation and capital mobility. The effects these two far-reaching phenomena will have can be assessed only partly on the basis of experience in other major industrial countries because of the peculiarities of the Italian financial system. Financial innovation relates not only to instruments but also to types of intermediary and entire markets in which dealing is becoming continuous and where demarcation lines are being blurred; increasing complexity is making for greater interpendence between operators and between markets and increasing the number of channels through which external influences are transmitted. Monetary policy must adapt, advancing steadily from control of the intermediaries that create money towards control of the market, from control of monetary and credit aggregates towards control of interest rates. The liberalization of capital flows will necessarily cause greater sensitivity to interest rate differentials and expectations regarding the exchange rates of various currencies; it follows that greater international capital mobility places an additional constraint on the conduct of an independent monetary policy and, at the same time, that the exchange rate becomes an instrument for transmitting monetary policy effects, alongside interest rates.

5.1.1. - *The present "modus operandi"*

At present, Italian monetary policy is still partly insulated from conditions in international markets by the remaining restrictions on capital outflows; however, the exchange rate is a variable to which the monetary authorities are paying great attention owing to the repercussions it has on a country such as ours, which is heavily dependent on international trade and where the main real and financial variables are still highly indexed. It follows that domestic interest rates are conditioned by rates in international markets, given the persistence of a balance-of-payments constraint that was eased only temporarily by the fall in oil prices.

In view of the constraints imposed by the management of the public debt and the financing of the state sector borrowing requirement, Italian monetary policy has hinged largely on controlling monetary aggregates, and especially on indirect control of intermediation by the banking system; interest rates are emerging as the basic indicator and channel for the transmission of monetary policy.

Monetary policy measures continue to concentrate mainly on the traditional credit intermediaries, despite the fact that the structural changes in financial intermediation since the beginning of the eighties have involved a steady erosion of the role of the banks, the development of new intermediaries offering banking-related services, the overlap between institutions operating in the short- and medium-term markets, the more recent rediscovery of the stock exchange as a source of finance, particularly for large enterprises, and the emergence of new institutions such as investment funds.

At present, the logic underlying monetary policy can be summarized as follows. The Bank of Italy is determined to keep the rate of growth in the M2 money supply and in total credit to the non-state sector in line with the trends approved each year by the Interministerial Committee for Economic Planning by regulating the monetary base and the banks' free reserves, the latter being particularly important from an operational point of view.

It is worth stressing that the process for determining the money stock is not controlled mechanically by the monetary authorities, except in simplistic models based on the deposit, credit and money multipliers. The public's desired ratio of cash to deposits and the banks' desired ratio of reserves to deposits interact to determine the actual stock of money. Both ratios depend on the level of short-term interest rates.

The money creation mechanism cannot be considered without reference to the process that determines the equilibrium of the overall financial portfolio if one bears in mind that the structure of real and nominal interest rates on the whole range of financial assets must be examined. Financial innovation has made it more difficult to predict this equilibrium and has forced the monetary authorities to set a target range for money supply growth for the past two years, rather than a single target figure.

In the context prevailing in Italy, the interest rate on Treasury bills has gradually become the "pivot" rate for controlling the growth in bank lending. When the Treasury bill rate rises — or rather, when the differential between Treasury bill yields and deposit rates widens — bank lending slows down. Raising lending rates restores equilibrium between the supply of and demand for bank loans by curbing demand.

Within this framework, monetary financing of the Treasury, which is the central bank's main means of intervening in the domestic market, cannot exceed the growth in total monetary base consistent with the planned expansion in money flows, bearing in mind nevertheless that there is only limited scope for offsetting opposing movements in the domestic and external components of monetary base.

It must also be stressed that there is a close link between credit-granting and the economy's demand for financial assets and hence between credit and the level and structure of interest rates that ensures simultaneous equilibrium in the credit, money and securities markets. The change in domestic financial assets is equal to the sum of:

a) the change in the economy's domestic indebtedness;

b) the state sector's domestic borrowing requirement (together, these two constitute total domestic credit); and

c) the overall surplus or deficit on the balance of payments.

In Italy too, the relationship between intermediate and final monetary objectives has been profoundly influenced by the transformation that has occurred in the financial sector. Innovation has greatly affected the credit market, which is no longer virtually the only source of finance for the corporate sector; it has had an even stronger effect on the demand for money. The new types of financial asset have transformed the funtion of money as a store of value.

Furthermore, innovations in monetary policy instruments have been significant, making it possible to control the monetary aggregates more effectively. They can be seen as seeking to obtain better control over monetary base and reducing the average value and volatility of the money multiplier.

5.1.2. - *From direct to indirect control of credit*

It is worth recalling briefly the series of measures whereby the change in monetary policy was gradually accomplished:

a) the "divorce" between the Treasury and the Bank of Italy in June 1981, which provided the essential instrument for controlling monetary base by removing the obligation on the central bank to underwrite Treasury bills not taken up by the public at auction;

b) the measures of December 1982 raising the compulsory reserve ratio on deposits and applying the same rules to "atypical" fund-raising operations, such as securities repurchase agreements with customers, thereby creating a closer correlation between the trend in the money supply and the behaviour of bank reserves and making the requirement fall more equally on the various types of credit institution;

b1) the substantial reduction in the securities portfolio constraint enacted at the same time;

c) the abolition of the ceiling on bank lending in June 1983 (followed by six months' monitoring of lending behaviour), save for the temporary reintroduction of the ceiling in the first half of 1986.

By eliminating controls on banks' assets (measures *b1* and *c)* but giving the Bank of Italy a substantial degree of control over the creation and use of monetary base (measures *a* and *c* respectively), so that the behaviour of the monetary aggregates became more predictable, these measures paved the way for the switch from direct to indirect credit control.

Technically, the "divorce" means that the Bank of Italy limits its demand for Treasury bills at auction to the amount consistent with the target for the growth in total monetary base. It is obvious, however, that if the Treasury's requirements are not met at auction it can always obtain funds by drawing on its overdraft facility, thereby creating monetary base. Hence it is clear that the Treasury has been given the main responsibility for setting the floor prices of government securities at auction and that the prices set are bound to reflect market conditions prevailing at that time. On the other hand, by using securities repurchase agreements the Bank of Italy can smooth out excesses and shortages of liquidity at interest rates that are the "true market rates", in these operations at least, and thus give the Treasury a guide to the plausible equilibrium level of floor rates for future auctions.

Competitive securities repurchase operations are one of the most important innovations in the Bank of Italy's armoury of instruments. As well as serving to mop up excess liquidity, they meet the need to finance the system, particularly when monthly returns show a high liquidity requirement on the part of the banks owing either to the system for meeting the reserve requirements or to the approach of particular deadlines. Securities repurchase agreements have sometimes been used to "prime" the system for auctions of government securities, thereby temporarily financing demand for such paper. In short, the correlation between bank liquidity and the public sector borrowing requirement has become less close.

The banks' gross free reserves have become less volatile; they have contracted in relation to the volume of deposits, thus reducing excess balances, in other words the part of their reserves that could provide the basis for an undesirable creation of deposits. The reduction in excess balances has therefore made bank liquidity less responsive to changes in interest rates, a factor that has helped stabilize the multiplier; the standard deviation of the deposit multiplier from its annual average value declined substantially in 1984 and 1985. Against this background, interest rates should theoretically have fluctuated more widely, since they depended more closely than in the past on the behaviour of the Treasury borrowing requirement.

5.1.3. - *Floating interest rates and monetary policy*

The impact of monetary policy has been strongly influenced by the more widespread use of floating interest rates on a large proportion of financial assets. Floating rates enable borrowers to avoid being locked into heavy debt servicing commitments if interest rates decline. For that reason, raising the cost of money would appear to be a less effective means of discouraging spending than in the past.

On the other hand, if the objective of monetary policy is to counter speculative foreign operations and the stockpiling of imported goods, over the very short term raising the cost of money is more effective if interest rates are floating. They mop up more liquidity and primarily hit speculative demand for credit without harming investment, since borrowers are not locked in.

In the short-to-medium term, the effects of monetary policy on aggregate demand are less clear than with fixed interest rates; nevertheless, if an increase in nominal rates is matched by a corresponding increase in real rates, monetary policy will have a restrictive effect on investment if borrowers expect a prolonged period of higher short-term rates, even if they are not locked in to high long-term interest rates. Moreover, in such a situation all those debtors whose debt servicing burden is close to the tolerable limit face the risk of bankruptcy; the fragility of the system therefore increases.

The existence of a large amount of long-term public debt at floating rates, as in Italy, gives rise to further problems and constraints for monetary policy. The difficulties are exacerbated by the fact that a restrictive monetary policy tends to inflate the budget deficit, partly for endogenous reasons but chiefly because a rise in the cost of money increases the burden of servicing the public debt; since the amount of outstanding debt at floating rates is high, the budget deficit is highly sensitive to variations in interest rates on government securities. In the shorther run, the state sector appropriates a larger proportion of the credit available and consumer demand tends to expand at the expense of investment.

5.1.4. - *The limitations on monetary policy*

In practice, the limitations on monetary policy that have emerged are the following:

a) interest rates are not allowed to fluctuate freely, except those at very short term. The reasons lie in the need to avoid destabilizing the financial markets and, with the ratio of public debt to GDP (old series) around 100 per cent in 1986, to prevent rises in interest rates from excessively increasing the burden of the public debt, a large part of which is at floating rates. To prevent interest rates fluctuating too widely, the monetary aggregates have in some cases been allowed to diverge at least temporarily from the target value. On the other hand, restrictions on the free movement of capital and "management" of the limits on banks' borrowing abroad can only partly insulate domestic interest rates from developments in international markets; this further limits the freedom of monetary policy;

b) in any case, the existence of a substantial volume of public debt instruments in circulation not only obliges the central bank to keep real interest rates high but also implies a high substitutability between loans and securities in the banks' balance sheets. This encourages the formation of a cushion of liquid assets which partly absorb and thus delay the impact of monetary policy measures on lending to the private sector;

c) further limitations on the pursuit of a monetary policy based primarily on the indirect control of lending by traditional intermediaries have been emerging of late. We refer to the effects of financial innovation, a process that is altering certain fundamental elements of the operational framework of monetary policy: the definition of money, the process of money supply creation, the demand for money and the monetary policy transmission mechanism.

5.1.5. - *Changes in the monetary aggregates and the growing role of the market*

The process we are examining here poses tricky problems for monetary control. Financial innovation makes it more difficult to define the monetary aggregates, because the range of financial instruments is gradually widening, their yields are in line with those prevailing in the

market and they are highly liquid. The dominant feature of financial innovation seems to lie in the growing fungibility of financial instruments and the consequent difficulty in drawing demarcation lines. In the institutional setting that exists in Italy, the introduction of Treasury bills and Treasury credit certificates at floating interest rates was followed by strong growth in certificates of deposit (CDs), which prompted the Bank of Italy to redefine the monetary aggregate used for control purposes by deducting CDs from M2 to obtain M2A.

In the foreseeable future, the introduction of new instruments that are close substitutes for traditional ones may put upward pressure on both the broad definition of the money supply and the effective monetary multiplier, calculated by reference to a monetary aggregate that is wider and more responsive to the new mix of financial instruments. This effect is magnified when substitution is towards new instruments that are not subject to reserve requirements.

Financial intermediaries' ability to create "broad" money can therefore be expected to increase, as will the volatility of "extended" money multiplier; this ability has been shown to be correlated directly to the restrictiveness of monetary policy. Furthermore, insofar as interest rates on banks' liabilities tend to respond more strongly to fluctuations in market yields, money supply creation might become less sensitive to interest rate levels. The elasticity of bank deposits to interest rate differentials *vis-à-vis* close substitutes would obviously rise.

This requires greater flexibility on the part of the central bank in setting targets for credit aggregates, a need that was met by the introduction of a "target range" for the growth in lending to the non-state sector in 1987 rather than a single target figure.

Similarly, liberalization is a form of innovation capable of modifying the channels through which monetary policy operates and its very "modus operandi". In a context of high capital mobility, the exchange rate effects of changes in monetary policy may be all the stronger the more efficient are the financial markets and the slower the reactions of productive sectors of the economy. A highly discretionary monetary policy may therefore be destabilizing and, *vice versa*, strong external shocks call for a monetary policy response which, in the absence of controls on capital movements or exchange controls in general, cannot but be centred on interest rates or, better, on the structure of rates.

Since Italy is a party to the EMS exchange rate agreement, the liberalization of capital movements should be regarded as a further constraint on the conduct of an independent monetary policy. The fact

that the authorities have slightly greater freedom than their counterparts in the leading country within the mechanism as regards monetary policy is due solely to the lira's wider band of fluctuation, a concession that was really supposed to be temporary.

The greater responsiveness of the exchange rate to monetary policy measures as a result of capital mobility means that the direct impact of monetary policy no longer falls on sectors that are traditionally susceptible to the cost and/or availability of credit, such as investment and housing, but on the import-export sector and the tourist trade. The effect of interest rates on macroeconomic conditions is compounded by the impact of the exchange rate on sectors that are most sensitive in this regard. Moreover, there is a danger that, unless offset by domestic monetary measures, a capital flow generated by exogenous factors will become self-perpetuating and will produce exchange rates that are unsustainable and inconsistent with the fundamentals.

5.2. - The need for a secondary market for monetary policy purposes

The secondary market is increasingly becoming the key component in the monetary policy transmission mechanism in all the more advanced countries. In Italy, the development of non-bank financial intermediaries, the gradual emergence of competition among financial institutions and an increase in the efficiency of the money and capital markets have begun to shift the centre of gravity of the financial sector from the banks to the market.

Accordingly, the monetary authorities are obliged to extend the scope of their measures to cover not just the banks but the wider credit market and especially the financial market in order to achieve their objectives. The existence of a large volume of public debt held in many different forms and spread among all categories of investor would tend to give the secondary market a greater role, because by acting in that market the central bank would be able to exercise control over all operators, including non-financial ones, and over the entire range of interest rates.

If one examines the main instruments of official intervention, it will be seen that changes in discount rate serve mainly to signal changes in monetary policy or in general economic conditions, while changes in the compulsory reserve ratio are designed to modify the behaviour of the

banking system via their effect on the deposit multiplier; neither enables the authorities to control other operators and market segments where the banks do not operate, except in a way that is too indirect. By contrast, open market operations influence the entire range of interest rates simultaneously (and with greater flexibility and precision), signal changes in monetary policy swiftly (since an efficient market is the best means of communication), help achieve the objectives by means of immediate and symmetrical action and produce results in all sectors of the economy gradually but more rapidly.

5.2.1. - *The lack of specialized intermediaries*

It is only in the secondary market that the complete readjustment of the structure of financial portfolios can take place and that excess demand for or supply of the various financial assets and liabilities can emerge, causing changes in price and yield. In a developed and efficient financial environment, the distinction between the primary and secondary markets is more an analytical necessity than an empirical reality, as shown by the operation of the Euro-market, one of the best examples of efficiency and transparency. In a market that is far from perfect, as in the case of Italy, the separation is much more clear-cut.

The lack of specialized intermediaries prepared to make a market is the underlying cause of this weakness in our financial structure; although the range is not wide, the volume of government securities on the market is large and sufficiently deep to justify the multitude of specialized operators that an active secondary market would generate. Although beginning to emerge in some areas, they are still not sufficiently numerous to form a market able to allocate financial resources efficiently. In particular, non-bank operators are not strong enough to take significant positions of their own, since there is no true money market in which to raise short-term funds, nor do they have direct access to the central bank, although like the banks they can already take advantage of deferred payment terms for the purchase of government securities.

Transactions in securities at all maturities thus remain largely the domain of bank treasury departments, which are subject to the constant ebb and flow of liquid funds. The Bank of Italy seeks to smooth out these imbalances directly by intervening, in some cases bilaterally, and thus by maintaining a very close direct relationship with banks individu-

ally. The lack of variety in market participants, almost all of whom are bank treasurers, makes market behaviour too uniform, so that the central bank is obliged to intervene to create the necessary counterparties.

In this situation, the Committee recommends encouraging the development of specialized intermediaries; to that end, it recognises the desirability both of admitting them to membership of the clearing house in order to avoid settlements in cash and of allowing them to obtain finance at the central bank.

A greater role by other investors, such as enterprises that have learnt to manage their treasury actively, and the arrival in Italy of intermediaries with long experience in other markets, particularly if they were encouraged in an appropriate way, might help plug this gap in our financial system; example, emulation and competition will be the best catalysts.

Apart from the need to encourage the emergence of new specialized intermediaries, it is also necessary to remove the distortions that reduce the competitiveness of existing institutions. The effects of the tax in lieu of registration and stamp duties ("imposta sostitutiva") are particularly important in this connection. As a result of the general shortening of maturities, the rate applied to medium- and long-term loans (2 per cent) and to those of any maturity in particular sectors (0.75 per cent) appear especially onerous. The tax has virtually ceased to serve its original purpose, becoming instead a veritable levy on borrowed capital.

The Committee considers that the distortions currently produced by this tax on loans could be attenuated by converting it from a one-off flat-rate payment on the capital disbursed or committed for each loan into an annual proportional tax on the year-end balance of loans disbursed.

This would essentially be a return to the tax treatment that existed earlier with the yearly "subscription" tax of Law 1228/1962 and result in the tax being related to the maturity of lending operations.

Alternatively, it would be possible to leave the duty essentially unchanged but to levy it at different rates, depending whether loans were secured or not, applying the present rate (2 per cent) only to loans so guaranteed and reducing it to a quarter for unsecured credit.

5.2.2. - *The insufficient variety of financial instruments*

Just as a plurality of operators fosters the working of the secondary market, so a multiplicity of financial instruments helps it develop and

contributes to its stability. A wide range of instruments opens the market to a greater number of investors by catering for their preferences and, at the same time, increases the financial portfolio of individual investors by offering a variety of assets with lower risk-yield covariance coefficients.

Financial innovation contributes to the rise in the number and quality of both intermediaries and instruments in the market, in a way not unlike that which occurs in the productive sector. At the same time, innovation permits market renewal and erodes monopoly positions; hence the need to allow ample scope for the introduction of new instruments, techniques and operators.

Government securities with remuneration based for the most part on a single interest rate — that on Treasury bills — have certainly not encouraged the development of a full-fledged secondary market. Treasury credit certificates were the means of financing a rapidly rising Treasury borrowing requirement at a time of high and volatile inflation by transferring the interest rate risk from the investor to the issuer; they have been widely held even by final investors, including small savers, even though their specific and novel liquidity characteristics make them more suitable investments for the treasury departments of banks and enterprises.

An optimum portfolio should contain financial instruments with three basic maturities, which are essentially those offered by money market paper (Treasury bills), medium-term fixed rate securities (Treasury bonds) and long-term securities, which are lacking at present.

With regard to these three basic instruments, the Committee is of the opinion that ample scope must be provided for innovation in order to satisfy the diverse preferences of both investors and borrowers. At the same time, the Committee considers that the central bank should have a wide range of securities at its disposal in order actively to manage the term-structure of interest rates and that the Treasury, for its part, should seek to foster a greater variety of instruments in order to satisfy differing demands, including that of the central bank.

5.2.3. - *Interaction between the primary and secondary markets*

With a huge primary market in government securities but a shallow secondary market, it would seem advisable to use every expedient offered by the one to develop the other.

Although experience to date with competitive bid auctions (for three- and six-month Treasury bills) and uniform price auctions (for twelve-month Treasury bills) has not been particularly encouraging from this point of view, the use of competitive bidding should encourage the emergence and growth of specialized intermediaries prepared to take up a large slice of an issue, or the entire amount, in order to retail it to final investors. Such intermediaries in turn have an interest in creating a broad secondary market in order to be certain that they can liquidate their positions. Market making in the secondary market would thus be the consequence of a highly competitive approach in the issue market. More efficient issue procedures in the primary market might foster the emergence of specialized dealers, who would in turn stimulate competition in the issue market to procure securities with which to trade. Obtaining a certain type of security, possibly on an exclusive basis, would place them in a position of advantage.

The Committee considers that this method, which would be difficult to use for to-day's extremely large issues of traditional government securities, would produce good results for the launching of new public debt instruments, which need a lead manager who will do his utmost to ensure the success of the operation.

A money market in which intermediaries can finance their positions quickly and flexibly is needed to make this new technique work well. Moreover, the market must show interest rate movements at all maturities so that intermediaries can perform their role as arbitrageurs. Excessively rigid control of daily fluctuations in interest rates would not encourage the activities of specialized intermediaries in this sector.

5.2.4. - *Securities repurchase agreements and outright securities transactions*

Open market operations make it possible to control the quantity of monetary base in the economy and the banks' liquidity, influence the ratio of securities to money determined by the market, modify the level of interest rates and influence the term-structure on a continuous, day-to-day basis. It is only in the secondary market that the central bank can achieve these objectives simultaneously with a single instrument by pursuing an active policy in a direct, diffuse and flexible way. It also enables the central bank to regulate more precisely the timing, extent and maturity distribution of its actions to control liquidity and, if need be, to keep its intervention secret.

As a rule, the Bank of Italy uses two instruments to exercise direct control over monetary base: fixed term advances and securities repurchase agreements. Outright open market purchases or sales of securities on the secondary market are almost non-existent, partly owing to the massive new issues of Treasury securities each week on the primary market.

The problem the monetary authorities must confront daily is that of controlling liquidity subject to sharp fluctuations due to the lack of synchronism between government expenditure and the issue of securities by the Treasury to cover the borrowing requirement. The central bank reacts to these fluctuations, which by their very nature are reversed in less than a month, by selling securities under repurchase agreements with maturities that match the settlement dates of Treasury issues and other commitments of the banking system or by making temporary purchases of securities to coincide with these settlement dates. Although in legal terms they entail concluding a formal forward transaction subject to stamp duty, securities repurchase agreements should be regarded as operations with a set repayment date to loan or mop up liquidity, rather than as open market operations. The Bank of Italy offers or seeks at auction funds (monetary base) for periods usually not exceeding three weeks, not particular securities selected according to maturity or other characteristics; for their part, operators pledge as security the paper they have in their portfolios at that time, safe in the knowledge that they will regain possession at maturity. The central bank cannot modify the interest rate structure by this means nor can it directly influence market expectations; securities repurchase agreements do not differ in substance from fixed term advances, except that the rate of interest is set by the market in the case of the former but by the authorities in that of the latter.

Securities repurchase agreements are offered to the banking system as a whole using the competitive tender method and without a floor price. This method of placement gives the interest rates at which they are concluded the flexibility needed for effective control of liquidity on a daily basis. Other countries are also making growing use of temporary market operations owing to the convenience of being able to effect spot operations together with transactions in the opposite direction that are known to be needed at a later date.

Greater recourse to outright open market operations is desirable, however, as part of a more flexible use of the instruments at the disposal of the central bank. This will be made easier in the foreseeable future by

the presence of new specialized financial operators in the government securities market in addition to banking intermediaries.

The disparities that might develop between secondary market yields and new issue yields is an obstacle to more frequent use of outright operations. Secondary market yields must necessarily be flexible to ensure complete control of bank liquidity, whereas new issue yields are more rigid. Any yield differentials that might emerge in relation to open market operations over the maturity spectrum might, in present circumstances, have adverse repercussions on the placement of new issues.

Accordingly, the Committee considers that more flexible central bank recourse to outright open market operations would help stimulate the development of the secondary market in government securities, permit a policy on the structure of interest rates to be pursued, as far as that is possible, and improve the management of the banking system's liquidity.

5.3 - Further proposals for monetary policy

The analysis of developments in the monetary and credit system and of changes that may occur in the implementation of monetary policy led the Committee to make a number of proposals aimed at improving the controllability of the aggregates in the present transitional phase and raising the efficiency of the credit markets and, *ipso facto*, the effectiveness of monetary policy based on indirect control.

5.3.1. - *Changes in reserve requirements*

Consideration of the effectiveness of reserve requirements as an instrument of control cannot be separated from examination of the costs they entail for bank fund-raising, which is subject not only to explicit taxation at a much higher rate than other financial instruments but also to an implicit tax due to the compulsory reserve. This has decreased substantially as a result of the fall in market interest rates, given that reserves in respect of deposits bear interest at 5.50 per cent, but it still amounts to around one percentage point of interest.

The Committee is of the opinion that in the near future consideration should be given to further reducing these costs and narrowing the differences in the treatment of different types of intermediary, while nevertheless taking account of their position in the process of monetary creation.

On the other hand, the effectiveness of reserve requirements as a means of controlling monetary and credit developments can be enhanced by:

a) shortening the lag in the adjustment of reserves inherent in the practice of crediting interest on bank deposits once a year;

b) using monthly averages instead of month-end data for fulfilling the requirement.

With regard to the latter point, the use of monthly averages would reduce both evasion and the problems arising from chance factors. The Committee is aware that the new prudential supervisory arrangements require the reporting of average data on deposits, but these will not come into effect until 1988. It is also obvious that the changeover to average data as the basis for calculating compulsory reserves will require sufficiently long statistical series, especially in order to quantify seasonal factors, which must be known in order to be able to set monetary targets on a monthly basis.

The first point therefore holds greater interest in the immediate future. The substantial lag between an expansion in banking intermediation and the deposit of the corresponding compulsory reserves reduces the monetary authorities' ability to exercise control, since increases in compulsory reserves are predetermined in the short run.

Apart from the interval between the date of deposit returns and that stipulated for topping up reserves (15 days in the case of banks and 25 in that of savings banks), which advances in data processing and data transmission have now made it possible to shorten, the real problem in Italy is caused by the practice of crediting interest on deposit accounts only once a year. The growth in deposit in December is now on a par with the expansion that occurs in the rest of the year; the full adjustment of compulsory reserves to the expansion in customer deposits is therefore lagged by an average of six months.

In the Committee's view, crediting interest more frequently — quarterly, say — would improve the effectiveness of monetary control. It would also help increase the stability of the securities market, which is often turbulent at the beginning of the year, when interest credited to accounts in December is reinvested.

The higher costs to the banking system resulting from crediting interest on eligible deposits quarterly could be offset by making a corresponding reduction in the average reserve ratio and possibly standardizing the rates on the increments of deposits, which are differentiated at present.

Finally, the Committee felt it would be advisable to abolish the exemption of rural and artisans' banks from reserve requirements when the scale and nature of their operations are similar to those of other banks.

5.3.2. - *Certificates of deposit*

There are positive aspects to the spread of certificates of deposit as a means for households and enterprises to hold liquid assets. The banks can plan their fund-raising more rationally, which among other things enables them more effectively to meet competition from other ways of investing short-term funds and to achieve greater stability of their deposit base. For their part, the monetary authorities can count on bank interest rates, and especially lending rates, being more responsive than rates set directly through monetary base policy. These were the primary reasons for the measures taken at the end of 1982 to encourage the issue of certificates of deposit, the main provision of which permitted a higher rate of interest to be paid on compulsory reserves in respect of CDs.

As from 1 November 1986 the monetary authorities amended the regulations governing CDs in order to make them better able to meet the needs of banks' customers, in particular by extending the higher rate of interest on reserves to three- and six-month certificates of 100 million lire or more. They also indicated the roles that the various types of intermediary could play in the secondary market in order to foster the development of these instruments.

In the view of the Committee, this is a fundamental point: the creation of an efficient secondary market in certificates of deposit should be a joint undertaking that should benefit both the banks and the monetary authorities.

A further development of the CD market might be envisaged. At the European level, the time has now come for the ECU to be accorded the status of a currency in all the countries belonging to the EMS. In order to strengthen the European currency, consideration might be given to establishing greater contact between the private and official ECUs, to developing the ECU as a medium of exchange and as a unit for expressing contracts and transactions, in short to consolidating and broadening its "habitat".

In the context of the gradual liberalization of capital movements in Italy, the Committee considers it would be interesting to examine instruments that can prevent or at least contain speculative movements of funds associated with expectations of changes in central exchange rates. Certificates of deposit the proceeds of which are used by the banks to grant loans in ECUs would represent a substitute for foreign currency securities in the portfolios of households and enterprises.

In addition, the use of the ECU would be a valuable exercise for banks and businesses alike in preparation for the internationalization of the unit by expanding its domain beyond that of the larger banks.

The introduction of a requirement for banks to absorb monetary base in lire would ensure that the creation of CDs in ECUs would not diminish control over the money supply and domestic credit. Since borrowers would in effect have a choice between ECU debt via the "international" banking system and the same via the domestic channels outlined here, the cost of "domestic" credit should not exceed that of international loans. Moreover, giving residents the possibility of holding short-term assets tied to the ECU could bring about some reduction in domestic deposit rates. The security would be denominated in ECUs, but actual payment would be made in ECUs only when exchange controls permitted.

5.3.3. - *Introduction of bank commission on credit lines*

The ratio of bank credit actually disbursed to that granted has declined markedly over the last decade. The trend was interrupted in the years when the ceiling on lending was at its most stringent — primarily in 1980 and 1981 — but it resumed at an even faster pace after abolition. Over the last ten years as a whole the ratio has fallen from 70 to around 50 per cent.

The current practice of the Italian banking system has encouraged customers to obtain credit lines in excess of their immediate needs. Holding several partly or completely unused credit lines entails no cost for the recipient, but allows him at the appropriate time to draw on the facility which offers the best conditions or quickly to reduce his borrowing from banks that have raised their rates more than the average for the banking system. Of course, in principle the bank can counteract this tendency, but in practice it is difficult for it to do so in times of keen competition (such as that which followed the removal of the lending ceiling), particularly where prime customers are involved.

The greater flexibility that major enterprises have acquired in liability management contributes to company efficiency, but it entails costs that fall outside the productive sector. First, it exposes the individual bank to a funding risk if the credit utilization rate of very large customers increases suddenly, an effect similar to that caused by the development of guarantee commitments. Secondly, it obliges the banking system as a whole to maintain precautionary liquid reserves that are not justified by the volume of credit actually disbursed. Above all, at times of particular cyclical tightness it may compromise control of the credit aggregates by the monetary authorities.

For these reasons, the Committee views measures to limit unutilized credit margins favourably. The simplest and most direct means available to the banks to curb low credit utilization is to charge commission on the credit line, either in addition to the existing commission on the maximum drawing, as in France, or in place of it. To be effective, however, the commission would have to be introduced by all banks simultaneously.

It will be recalled that the Bank of Italy has carried out a similar reform in its relations with the banks; in May 1985 it introduced a commission on its overdraft facilities, for reasons not dissimilar to those indicated above.

5.3.4. - *Interbank markets*

Viable and efficient interbank markets are a central element in the banks' integrated management of their assets and liabilities. In particular, they are essential for liability management, which is a fundamental characteristic of financial innovation, internationalization of markets and intensification of competition. The importance of interbank transactions is rising, not only in the international market but also in individual national markets. Italy is no exception in this regard, although development of the market in terms of efficiency and speed of response to changed liquidity conditions is relatively recent and confined to the overnight market, the area most directly associated with management of banks' liquidity positions and of the payments system; the trend could be further encouraged by greater flexibility in clearing operations.

The Committee considers that it is also necessary to expand the more "structural" segment of the interbank market, which matches the demand for and supply of true finance between banks, by widening membership of

the market and increasing market efficiency. Moreover, it could be an ideal "habitat" for new financial instruments, in particular options and futures.

Taxation emerges as one of the main obstacles to expansion of this market owing to the 25 per cent provisional withholding tax on interest paid; it makes the banks creditors of the tax authorities for growing amounts because of the debatable classification of such interest as income from capital, whereas it may more properly be regarded as a component of business income.

The Committee therefore considers that it would be appropriate to reduce the rate of provisional withholding tax or, if it were kept unchanged, to base assessment on only a portion of the interest paid.

The shorter-term part of the market would then be made more fluid by the adoption of predetermined criteria on the recording of quotations and other aspects connected with the regulation of transactions. It would also be an advantage to widen the range of maturities in order to provide more flexibility in adjusting positions. On the other hand, venturing beyond the very short term might involve the banks in the risk of illiquidity, together with a degree of inflexibility.

For this reason, the Committee considers that interbank certificates of deposit exempt from reserve requirements are appropriate instruments for the banks to achieve more effective balance sheet control.

In view of the overall size of the market, operational efficiency would be enhanced by greater integration of treasury operations in domestic and foreign currency within individual banks.

In the opinion of the Committee, this development would be made easier by greater liberalization of the rules governing the banks' forward foreign exchange operations.

5.3.5. - *The Treasury's overdraft facility and auctions of securities*

The provision linking the overdraft limit on the Treasury's current account with the Bank of Italy to the volume of approved budget expenditure for the year has hampered control of the monetary and credit aggregates. It has caused both the Treasury's borrowing ability and its debt to rise by an average of more than 25 per cent a year over the past decade.

If the rate of growth in government expenditure systematically and significantly exceeds the growth in GDP, keeping the expansion in the money supply in line with GDP growth requires a steadily rising

compulsory reserve ratio if the balance-of-payments position is to remain unchanged. Moreover, this distorts and unbalances the reserve requirement instrument, since it tends to increase the constraints on the banks' operations and to raise their costs.

This enhances the validity of the approach for the adjustment of the public finances that seeks to bring the rate of growth in expenditure below that in gross domestic product, at least for a period of several years.

In situations in which government expenditure persistently grows faster than GDP, the Committee believes it would be desirable to review the overdraft mechanism in order to give greater control over money creation. In that context, consideration could be given to setting a ceiling on borrowing under the overdraft facility as a percentage of the cash deficit on the government budget approved by Parliament.

Management of money and credit aimed at restoring and subsequently maintaining stability requires that the government raise its finance in the market in the first instance. Considerable progress towards satisfying that requirement has been made, particularly when the underwriting of securities at issue by the central bank became discretionary at the end of 1981. In 1982 net purchases of government securities by operators in the primary market amounted to 42 per cent of total net issues. In 1986 the proportion was 89 per cent. The role of Bank of Italy intervention in the primary market decreased accordingly.

The Committee considers that the process should be reinforced; the need to strengthen the secondary market suggests that it would be appropriate for the central bank gradually to transfer its monetary policy interventions to that market.

This would constitute a concrete affirmation of the principle of separation between control of the monetary base and management of the public debt, which implies, at a more general level, the co-ordination of monetary and fiscal policies.

For this to occur, however, it is obvious that the question of the placement of securities in the primary market must be resolved. A reduction in the borrowing requirement and a lengthening of the maturity of the public debt are prerequisites in this regard.

With a view to gradually reducing the borrowing requirement, the Committee considers that steps should be taken to move towards a primary market able to absorb issues of securities without the direct support of the central bank. To that end, the auction mechanisms should be reviewed and gradually strengthened in line with the development of specialized

financial intermediaries. In the case of Treasury bills, it would be advisable to restore an adequate margin between the auction floor price and current prices. Moreover, it appears to be desirable to reintroduce or to introduce the auction method for medium- and long-term securities as well, including those linked to the cost of living index.

Increasing recourse to the auction method of allocating securities could usefully be supplemented by "tap" issues of long-dated securities aimed specifically at non-specialized investors, especially households. In this case, the overall volume would be adjusted by varying the amount offered at auction on the basis of careful monthly planning of borrowing requirements.

Section 6. - Public debt policy

6.1. - Financial wealth and the demand for government securities

Recapping what was said in Section 2, wealth and saving are determined fundamentally by disposable income, net of cyclical and random movements; they are also influenced by the rate of growth in economic activity and productivity, the age structure of the population, the length of the working life and interest rates. These variables also affect the desired ratio of wealth to income. There is therefore no reason to believe that the desired level of wealth or the desired ratio of wealth to income for the individual and for the national economy in aggregate depend on the level of public debt or the ratio of the latter to GDP.

Available information on a number of economies confirms that the assets held in the form of national debt instruments is not correlated to investors' total wealth. In particular, the ratio of national debt to aggregate wealth varies a good deal from one economy to another and from one period to another within any one economy. By contrast, the ratio of wealth to disposable income or gross domestic product appears to be stable, apart from cyclical fluctuations.

Since *ceteris paribus* the growth in disposable income determines the increase in wealth, the latter and portfolio choices combine to determine the potential uptake of public debt instruments by residents. If and when the amount of public debt outstanding exceeds that potential, one or other of the two processes of financial instability described in Section 2 restore the wealth/income equilibrium desired by investors. We repeat that an analysis of the likely behaviour of the demand for government securities and for financial assets in general in the years to come is valid only on condition that the adjustment in public finances does in fact materialize.

6.2. - The characteristics of public debt instruments

In order to define and describe the demand for government securities, it is worth recalling the characteristics of the relative risks they bear. Since sovereign issuers normally enjoy unimpeachable credentials, the payment of interest or coupons and repayment of the principal are certain, so that such assets entail no credit risk.

The security is, however, subject to an interest rate or price risk; the future market value may differ from that which the purchaser expected at the time of subscription, expressed as an average of probable future prices (over the subjectively held probability distribution of their outcomes). The disparity may be in the absolute level of the disposal value and/or in the latter in relation to the price of alternative financial assets. There is also a second risk, the real value risk in terms of goods and services; the future purchasing power of the capital invested in a security and that of the income it produces may differ from the real values the purchaser expected at the time of subscription on the basis of the average of probable future rates of inflation (over the subjectively held probability distribution of future inflation rates).

Available empirical evidence for a number of currencies indicates partial correlation only between the two above-mentioned risks at the various maturities and between different currencies. For the purposes of public debt policy, it is necessary for investors to be aware of this relative independence. Experience shows that such a perception exists; in particular, it should be considered that each of the two risks generates a time schedule of investor expectations of the rate of interest and the rate of inflation over any given future time span.

It follows that in principle different combinations of these risks may be formed for each future maturity to define particular public debt instruments. For example, the yield on each medium- or long-term instrument may consist in part of a fixed coupon and in part of a rate of interest that varies as a function of other rates, price indices or GDP price deflators. Furthermore, the relationship between the fixed and variable components of the coupon may change over time.

Up to now, we have not considered the liquidity risk that may attach to medium- or long-term public debt instruments. To be more accurate, in the case of such securities one should speak of a risk that there will be no market (in other words, operators ready to meet demand and supply in the volume sought by final investors in the secondary market) and a risk of market weakness (that is to say, a limited volume of buy and sell orders to intermediaries and brokers to be executed at prices above and below current quotations).

It is appropriate to recall here that in the case of the stock market "strength" generally implies the following three characteristics:

a) depth, *i.e.* the presence of orders for a wide range of prices;

b) breadth, *i.e.* a high volume of orders in relation to the volume of securities in circulation and their coming from a cross-section of investors;

c) resiliency, which is present if the market rapidly receives a large volume of new orders as a result of unexpected changes in the structure of prices.
Strength is closely related to the working of the secondary market (cf. Section 5).

As to the variety of securities it may suit the Treasury to offer in the market in a given period, it seems possible to sketch only the broadest of hypotheses describing the structure of demand from various types of operator, for two main reasons.

First, with expectations of a slowdown in inflation and hence of a fall in interest rates, floating rate securities will become less attractive to final investors and less interesting to the issuer. For this reason too, it is reasonable to suppose that in the near future the public debt will comprise a growing proportion of fixed rate securities. It is worth noting here that Treasury credit certificates, the medium- and long-term floating rate securities currently available, do not afford a significant opportunity for diversifying away from Treasury bills; by definition, the yields on these two kinds of security will always move in tandem. On the other hand, it should be stressed that Treasury credit certificates are certainly not perfect substitutes for Treasury bills on account of their longer term and the delayed indexation mechanism. It is the broad market for Treasury credit certificates that makes them sufficiently liquid to compare favourably with short-term securities, particularly in times of falling yields.

Secondly, since the demand for every type of government security is generated by the portfolio choice mechanism, it interacts with other financial choices made in the economy. In that context, the growth in the fixed income component of total public debt alters the substitution and complementarity relationships between the various forms in which financial wealth can be invested. Hence, it would be simplistic to extrapolate developments in the near future from what took place before 1973, a period when debt consisted predominantly of medium- and long-term fixed rate securities. Available evidence indicates that final investors now display much greater financial maturity than before 1973. Among other things, the greater sophistication of operators' decisions interacts with the volume and frequency of financial transactions, which have increased substantially since the sixties.

Market experience and practice will be essential to identify the combinations of interest rate and purchasing power risks most attractive

to the various types of operator for various maturities. However, the factors to be borne in mind in offering government securities are:

a) the yield expected by subscribers from the various combinations of risks inherent in the securities;

b) the elements that in principle combine to define the "habitat" of various government securities.

6.3. - The state sector borrowing requirement and the strategy for managing public debt

The planned stabilization of government finances and the consequent elimination of the deficit net of interest payments by 1989 will not succeed in bringing the average 1987-89 borrowing requirement below 10 per cent of GDP.

At the same time, the amount of debt to be replaced annually can be put at an average of around one quarter of GDP for these three years. It follows that annual issues of government securities will rise to at least 35 per cent of GDP, far higher than in any other industrialized country.

Of necessity, monetary policy and debt management will be closely interlinked both in the creation of monetary base and in determining the level and structure of interest rates.

In this context, the strategy for monetary policy and public debt laid down in 1981-82 remains as valid as ever. Hence, the public debt must continue to be managed in such a way that it does not constrain the autonomy of monetary policy, and nominal interest rates (and, *a fortiori*, real ones) on public debt instruments must remain at the level needed to finance the borrowing requirement and achieve the monetary policy objectives. It is essential that the deficit continue to be covered in the market and not in spite of the market; against the background of financial innovations and steadily increasing liberalization of international capital flows, macroeconomic and microeconomic management that disregards the price mechanism becomes increasingly ineffective and inefficient.

In other words, policies based on administrative controls and curbs hamper the financial system in the allocation of wealth among the various alternatives available, create pricing mechanisms for financial instruments that do not cause markets to move towards equilibrium, and build up imbalances that cause increasingly rapid circumvention of

the administrative constraints, inducing the development of new instruments and new contractual, accounting and dealing practices designed to that end. Administrative controls and requirements are partly responsible for the Italian financial system's loss of competitiveness by comparison with the rest of the world. In turn, this erosion of competitiveness manifests itself in the survival of archaic dealing practices which, among other things, obstruct the formation of a secondary market.

6.4 - Treasury and operator preferences in issuing securities

Traditionally, liquidity constraints and the need to hold precautionary balances oblige operators to accept low yields in return for relatively short maturities. Hence in the case of banks, short-term uncertainties regarding deposits generate a demand for government securities for liquidity purposes, for which such instruments appear particularly well suited, since they entail low transaction costs and limited nominal value risks. Furthermore, seasonal requirements caused by imbalance between customer demand for loans and the trend in deposits can be covered by selling government securities. The demand for such securities may sometimes complement lending activity rather than replace it.

The preferences of the treasurers of non-financial enterprises as regards financial instruments are shaped partly by the time pattern of cash-flow. This will depend on any seasonal trends in receipts, the regular cycle of payments of salaries, pensions, social security contributions, taxes and interests, and the random due dates of other kinds of payment. In the short term, funds due to be paid on known dates can be invested in Treasury securities with matching maturities. Developments in payments technology and changes in the techniques of managing monetary and financial balances appear to have made the timing of some payments and receipts more predictable over the short term. Viewed from this angle, government securities may serve as substitutes for bank deposits and financial assets complementing bank debt at sight or short notice.

Growing competition in the money and financial market is narrowing the spread between fund-raising and lending rates for non-bank operators. At the same time, financial innovation is enabling them to diversify the range and characteristics of funding and lending instruments. Empirical evidence indicates that major operators are simultaneously increasing their bank debt and their holdings of liquid financial assets that give adequate returns. Analysis of the data shows that the wider the spread between bank deposit and lending rates the greater the incentive for non-bank operators to trim both their short-term borrowing and their investments in short-term financial instruments. *Vice versa*, the narrower the spread, the more they are interested in expanding financial intermediation.

In short, the demand for short-term government securities is probably directly proportional to yield differentials between such paper and other money market instruments and inversely related to spreads between bank deposit and lending rates.

Account should also be taken of the specialized stock market operators to be created or encouraged in the way described above. One of the aims of such an undertaking is to increase the turnover in a given security. The greater the volume traded, the easier it becomes to dispose of the security quickly and the less its price can be affected by adverse changes in yield expectations or by increases in the risk the market attributes to it.

The spread of share ownership and the increasing tendency for small firms to make direct issues of bonds entail an expansion in market making. The supplier of liquidity services typically holds short-term funds and is therefore a potential purchaser of short-term Treasury paper.

The uncertainties surrounding future trends in real income from employment and self-employment net of tax and in real yields on capital are relevant to the demand for fixed rate government securities of all maturities as a result of the covariance between labour incomes and income from capital.

A part of wealth is accumulated in order to supplement future pensions and/or to have capital to leave to one's heirs. In countries for which fairly reliable estimates of this component are available, at least one quarter of households' total wealth is attributed to this motive. It is reasonable to suppose that by preference this portion of wealth is invested in real property, shares and/or long-term bonds, possibly indexed to the cost of living. Life assurance companies and pension funds are inclined to prefer fixed income securities with maturities matching that of their contractual obligations towards policy holders. Obviously, the possibility of investing in securities indexed to the cost of living may widen the range of policies they can offer their clients.

The existence of transaction costs and price risks means that, with their general aversion to risk, operators prefer as far as possible to match the above-mentioned needs with the maturity of the financial asset subscribed unless the range of instruments is considered inappropriate to the nature of the risks they bear and/or their expected real yield is too low.

The *a priori* considerations above suggest the classic triple segmentation of demand for government securities, which is in fact the same for all markets: short-term securities (with maturities of less than 18 months), medium-term securities (with a life of not more than 4 or 5 years) and long-term securities. As stated previously, the choice of the most appropriate maturities among the three categories must be based on experience. In addition, it should be borne in mind that there seems to be a greater chance of strengthening the market if the range of maturities issued is relatively narrow.

6.5. - Interrelationship between monetary policy and debt management

It has been stated that in the near future management of the public debt will be shaped increasingly by the size of the fixed component in the yield on securities and a corresponding reduction in the floating rate component. In this context, the existence of preferred or natural "habitats" for the various types of investor takes on particular importance. It implies that for the residual term corresponding to their "habitat" operators are prepared to accept a rate of return below that at which they are prepared to underwrite securities bearing other maturities. Moreover, securities with different residual terms are increasingly imperfect substitutes for one another the greater the fixed component of income in nominal terms. It is worth recalling that the important aspect of substitutability consists in the positive covariance normally present between movements in interest rates over the entire range of maturities; an increase in the supply of securities with a particular residual maturity by comparison with others causes a fall in the market value for that maturity and, to a lesser extent, in those of securities with different residual terms; the opposite applies in the case of a reduction in supply.

The expansion in the fixed yield component appears to have relevance for the effectiveness of monetary policy. Above all, it is

probable that monetary policy objectives will be set by reference to the interest rate structure. It is widely held today that monetary policy can control short-term rates directly. However, according to some observers, expenditure on consumption and fixed investment depends on the monetary aggregates, which the monetary authorities do not appear able to control effectively; others believe it is influenced to a greater extent by long-term interest rates. This second hypothesis appears to enjoy increasing acceptance; insofar as it adequately reflects the true state of affairs, it follows that the transmission mechanism of monetary policy is based at least in part on the behaviour of the term structure of interest rates. In particular, thanks to substitution effects, changes in short-term interest rates should have an impact on long-term rates and influence expenditure decisions.

However, there has been a noticeable and, in some cases, very considerable change in the transmission mechanism in the main economies over the last fifteen years. For example, in the United States long-term interest rates have appeared to be excessively high in relation to short-term rates by comparison with what might have been expected from past experience. By contrast, in Canada, Germany and the United Kingdom long-term interest rates have been distinctly lower than might have been predicted. In short, existing analytical techniques do not adequately explain the spreads between interest rates over the maturities range. The most disturbing aspect of this development is that changes in short-term interest rates induced by monetary policy have affected long-term rates to an extent that cannot be satisfactorily forecast by available models.

On the other hand, the belief that changes in the maturity composition of the public debt have a significant and predictable influence on security yields is steadily gaining ground. In particular, thanks to the "habitat" referred to above, they alter the slope of the yield curve for government securities and also cause changes in the yields on private sector securities, including shares. The maturity composition also influences decisions by intermediation and production sectors owing to changes in the liquidity of financial assets.

The conditions that determine the effectiveness of public debt management are:

a) that government securities at various maturities are imperfect substitutes for one another;

b) that long-term private sector bonds and shares and long-term government paper are relatively close substitutes among themselves or complementary components of investor demand.

The steady growth in the fixed rate component of public debt at the various residual terms allows monetary policy intervention to be extended beyond the narrow confines of the short-term market. Open market operations at a number of maturities reinforces the monetary authorities' ability to control operators' expenditure.

6.6. - Proposals regarding new and existing government securities

With the stabilization of inflation and the return to a normal interest rate structure, medium- and long-term fixed rate securities can again offer a higher yield than Treasury bills and the government's borrowing requirement can be met by means of issues that are not indexed to short-term rates. For their part, Treasury bills should serve increasingly to iron out peaks and troughs in cash positions. Above all, it should be possible to increase the variety of instruments offered, in terms of both characteristics and maturities, in order to widen the range of options that meet investor preferences and at the same time assist the central bank in its task of managing the structure of interest rates. Enhancing the range of public debt instruments will at the same time bring greater stability to demand and the bond market in general.

At this point it should be stressed that public debt policy will benefit not only from greater variety in the instruments representing relatively independent risk situations but also from the use of placement methods that help the market achieve equilibrium.

Reiterating the statements made in Section 5, the Committee is of the opinion that in order to increase the efficiency of management of the public debt, among other things, it is desirable to make increasing use of auction methods for the placement of new issues, which would boost market efficiency and benefit the public finances.

Without going into further technical detail, it is sufficient to note that a floor price for securities at auction is justified until such time as the market proves itself sufficiently mature through the emergence of specialized intermediaries. A floor price serves to curb excessive volatility at the expense of the Treasury; it is a prerequisite for the use of the auction method with the market structure as it is at present. There is no contradiction between this and the possibility of making "tap" issues of securities aimed directly at households, such as already occurs in the case of Post Office savings certificates, for example.

Treasury bonds will continue to be issued, since fixed rate securities are the bedrock of any public debt; the number and length of maturities on offer will be adapted steadily as interest rate expectations stabilize. Though the risk of abrupt interest rate movements is diminishing, floating rate Treasury credit certificates will long continue to be attractive to investors and issuer alike. They are designed mainly for banks and other intermediaries that cannot assume an interest rate risk and must keep the cost of liabilities in line with the yield on assets.

A wider range of maturities also appears desirable in the case of Treasury credit certificates, but a gradual reduction in the spread will be possible only as placement of the securities shifts from final investors to intermediaries averse to interest rate risks.

The new discounted Treasury credit certificate could be issued for a wider spectrum of maturities once experience has been gained. In the light of repeated response from the market, its structure can be adapted to suit the preferences expressed by the public.

The Committee considers that the deep discount could be replaced by a fixed coupon coupled with a variable one; the two kinds of mixed coupon security could coexist.

The issue of Treasury credit certificates indexed to prices has been opposed hitherto since it has been regarded on the one hand as a surrender to inflation, which has been fought partly by loosening the link between prices and wages, and on the other as a means of deferring the nominal part of the debt burden; however, it should be viewed with less hostility today. Not only are prices tending to rise less rapidly than in the past but accounting procedures have been developed to make the future burden clearly visible in the budget. Certificates of this kind can enable the Treasury to issue at a real interest rate below that required on other types of security, since it embodies no premium against the risk of changes in the purchasing power of money.

In view of the probable expansion in supplementary pensions, among other reasons, the Commission recommends that repeated issues of price-indexed Treasury credit certificates be made.

Among the new forms of security, zero coupon bonds may find a market, as demonstrated by the two issues by Enel and the State Railways last year.

In this regard, the Committee considers that a plurality of maturities from five to twenty years and the possibility of targeting the securities at particular purposes, such as saving to purchase a house, are worthy of close consideration.

In view of the progressive liberalization of capital movements, the creation of a domestic market in short-term Treasury securities in ECUs would ease the pressure of demand for foreign exchange that may result from portfolio adjustment by resident operators and would thus have a beneficial effect on the balance of payments. The creation of a sufficiently broad and deep market in such securities would also make it easier for private ECUs to be held in official reserves and would give the central banks greater scope for exchange market intervention in the Community currency as an alternative to the use of Deutsche Mark or dollars, as the case may be.

In particular, the Committee holds the view that the issue of Treasury bills in ECUs as well as Treasury credit certificates in ECUs would complete the range of maturities. Moreover, substituting ECU Treasury bills for part of the issue of conventional bills might help, at least marginally, in efforts to reduce short-term lira interest rates, thereby having a beneficial effect on the cost of Treasury debt in national currency and, in particular, of that in the form of Treasury credit certificates.

The Treasury could widen its range of issues on foreign markets, again within the context of the progressive liberalization of capital movements.

This might be achieved by maintaining a discreet but permanent presence in the new issue market. From a structural point of view, however, borrowing abroad should be held within the limits consistent with long-term equilibrium in the balance of payments on current account. The international debt crisis is too serious to ignore its lessons. The situation is different, however, in the case of the Treasury offsetting movements in the portfolios of Italian residents; this may take place mainly in connection with adjustments in the stock of financial assets according to currency, market and issuer that are expected to occur as a result of the complete liberalization of foreign exchange transactions.

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