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FOR THE YEAR

1955

PRESENTED TO THE

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 30th MAY, 1956

Excerpts from the Governor's Concluding Survey

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XII. *Excerpts from the Governor's Concluding Survey*

Gentlemen:

in this final section I shall try to summarize the main economic trends which form the background to the developments in the position of the assets and liabilities of the central bank, as reflected in its end-of-year statement of accounts.

Production in Italy reached especially high levels in 1955, outstripping any other year of the postwar period. This exceptional growth, which is measured by an increase in real income of 7.2 per cent over the preceding year, resulted from an increase of 9.3 per cent in industrial production, approximately equal to that of 1954, accompanied by a notable rise in agricultural production (6.0 per cent), which had shown rather modest percentages of increase in some important sectors, especially that of grain, in the preceding year.

The increase of 7.2 per cent in national income ranks Italy in second place among the principal countries of Western Europe in 1955, preceded by Germany, which showed an increase of 10 per cent.

In 1954, Italy had shared third place with Sweden, with an increase of 4.6 per cent in national income, being preceded by Germany (8.5 per cent) and France (5.9 per cent).

In industrial production (excluding building), which perhaps serves more adequately as a frame of reference for useful international comparison of economic growth, Italy occupied third place in 1955, with an increase of 8.3 per cent, after Germany (16 per cent), and France (10 per cent).

The preceding year Italy had occupied second place, with an increase of 9.7 per cent, after Germany (12 per cent) and on a par with the Netherlands.

If the comparison is extended to the entire three-year period of 1953-55, Italy's position appears in an even more favorable light, since she shared only with Germany and the Netherlands the distinction of having achieved a constantly high increase in industrial production throughout the period.

The higher income obtained in 1955 permitted an increase in private consumption of 4.4 per cent and an increase in fixed investments of 9.7 per cent, if housing construction is included, and of 6.9 per cent, if it is excluded. These investments represented 21.2 per cent and 15.8 per cent, respectively, of gross national income.

The increase in investments is indirectly confirmed by the rise in the index of production of capital goods which, after having increased from an average of 185 in 1953 (1938 = 100) to 205 in 1954, or 20 points, went up 33 additional points in 1955.

The results obtained last year have therefore been very encouraging, whether considered in themselves or compared with the results obtained in countries better endowed than Italy with natural resources or wealth accumulated throughout many years of economic progress.

Italy's problem, at least for the years immediately ahead, is therefore not to surpass the rate of development achieved in 1955, which, for national income, went considerably beyond the rate of 5 per cent envisaged in the ten-year plan for the development of employment and income, but to direct productive efforts, and the expenditure of the income that will be obtained, into the best and most profitable channels.

Financing of Production and Trade.— A comparison of the balance sheet of the Bank of Italy as of December 31, 1954 and December 31, 1955 shows that its loans were reduced by 4 billion lire during the year, while the financing of foreign exchange increased by 56 billion, resulting in a disbursement of 52 billion which went directly into productive activity.

On the other hand, 63 billion lire in the form of commercial banks' statutory reserves together with 30 billion as free deposits, totalling 93 billion, flowed to the Central Bank. Thus, the market and, above all, the credit system contributed with the difference of 41 billion lire to ease the pressure exerted on the money supply by Treasury drawings, besides, of course, aiding directly in Treasury financing, principally through subscription of Government securities.

Nevertheless, the credit system did not play a smaller part in the financing of production and trade in 1955 than in 1954. The total loans of the entire credit system, which had risen 727 billion lire in 1954, showed an increase of 855 billion in 1955, or of 128 billion between the two years.

Whereas the increase in the credit system's loans had averaged 469 billion lire a year during the four-year period 1948-51, the average increase over the last four years was 744 billion, approximately two-third higher. The increase in 1955 exceeded by 82 per cent the average increase of the four-year period 1948-51.

The amount of 855 billion lire which measures the loans of the credit system, added to an aggregate sum of 206 billion representing loans of the Institute for Industrial Reconstruction to the institutions under its control, loans of the Central Post-Office Savings Fund to municipalities, provinces, building cooperatives, etc., and loans of insurance companies (public and private, and social-security institutions) for investments of reserves, produces a total of 1,061 billion lire distributed by the public and private agencies which provide for Italy's credit needs either as their institutional function or as a corollary to their other activities.

To obtain a complete picture of the money that flowed into productive activity, the funds received from direct sale of shares and debentures to institutions and individuals other than the credit system proper must also be considered. In the year under review this amount was 159 billion lire (against 153 billion in 1954).

All in all, after the elimination of insignificant duplications, loans to the private sector increased during the year by 1,206 billion lire against 1,050 billion in 1954, a difference of 156 billion between the two years, of which 128 billion lire was accounted for by the credit system as a whole.

To this tremendous demand must be added that of the Government, which, beside using tax proceeds, property income, and other minor receipts in the amount of 2,308 billion lire, required an additional 446 billion, against 455 billion in 1954, including money obtained through the issue of bonds on behalf of the National Railways.

In sum, liquid funds in the amount of 1,652 billion lire were required in 1955, against 1,505 billion in 1954, an increase of 147 billion.

To meet this huge need, use was made, above all, of savings deposits, accumulated in the amount of 371 billion lire in the credit system and 95 billion in post-office savings funds, as well as other bank accounts in the amount of 61 billion, totalling 527 billion lire (4 billion less than in the preceding year), plus the funds flowing to the reserves of social-security institutions and insurance companies in the amount of 104 billion (4 billion more than in 1954), and finally, the amounts obtained on the capital market by the Government, special long- and medium-term credit institutions, and private institutions in the form of shares and debentures for a total of 450 billion (41 billion more than in 1954). Altogether, the figure that can be regarded as true savings amounted to 1,108 billion lire, showing an increase of 41 billion over the preceding year.

In addition, the funds known as « bank money » were used, i.e., current account deposits, cashier's checks, and other checks in the credit and postal systems, for a total of 372 billion lire against 238 billion in the previous year, as well as the portion of foreign aid directly accruing to the Treasury and going into lire counterpart funds, for 4 billion against 50 billion the year before.

To cover the entire demand, use was made of other funds flowing to the credit system (in connection with foreign exchange

accounts and accounts of minor credit institutions) in the amount of 62 billion lire, against 87 billion in 1954, and, finally, the issue of notes and coins, which amounted to 90 billion lire in 1954 and 134 billion in 1955.

The listing of the sources of the money supply in 1954 and 1955 and of its uses suggests certain considerations which cannot be disregarded if it is desired to appraise correctly the financial and monetary activity accompanying the growth of Italy's production.

The increase in 1955 of 133 billion lire in the circulation of only the notes of the Bank of Italy was the highest annual increase experienced since 1948; however, this circumstance loses much of its significance if account is taken of the fact that it resulted from those special factors which influence circulation in December of each year and which had been less actively operative at the end of 1954 than usual.

Proof of this is the behavior of the increase in banknote circulation determined as of January of last year and in January of this year. Measurement of the increase for the twelve months from the end of January 1955 to the end of January 1956 rather than on the basis of year-end data shows 103 billion lire instead of 133 billion.

The increase between the latest available figure (April 30, 1956) and the corresponding figure for 1955 proves to be 109 billion lire, still a considerably lower figure than that recorded at the end of 1955.

To appraise better, even though not fully, the normality of the development of the money supply — which in any case is not in itself capable of revealing whether or not there is a state of actual or potential inflation on the market — the ratio of the annual average circulation of notes and coins to national income may well be considered.

This ratio barely varied in 1955 from its 1954 position (14 per cent against 14.2 per cent).

As to the total money supply, i.e., with the addition of cashier's checks, other checks, and bank current accounts to notes and coins, its ratio to national income was approximately 35 lire to every 100 lire in both 1954 and 1955.

* * *

The heavy increase in deposits which has been taking place from year to year in Italian commercial banks may indeed cause surprise in certain foreign countries, since, under the conditions prevailing in those countries, such increases would be clear symptoms of inflation, to combat which they are frequently not content to reduce the rate of increase of deposits, but even attempt to contract the volume and often to no small extent.

However, account should be taken of various circumstances that explain this difference in attitude — the policy of repressed inflation pursued by those countries in the war years, which left an excess liquidity that is still in the process of being reabsorbed; the less marked rate of increase in national income shown by their economies, with the full use of their productive capacity and manpower; and finally, institutional differences in the banking system. In Italy, in fact, the banks are not only depositories of bank money, which, as is well known, they themselves help to create (and the excessive use of this power may be translated into an inflationary pressure), but also depositories of private savings in large amounts.

Consequently, to find whether inflationary pressures have appeared on the market, the inquiry must be made in other directions and, in particular, through examination of the development of consumption and investment, the movement of inventories in relation to their nature, the behavior of prices of Government and private securities and, above all, the behavior of wholesale and retail prices.

Some of these points will be considered later in this report, which will conclude with an analysis of price movements.

Meanwhile, to return to illustrate the credit system's action by supplementing the absolute figures already given, the

total credits granted by what are called ordinary institutions were expressed at the end of 1955 by a figure 115 times higher than that recorded at the end of 1938.

The volume of ordinary credit aiding the productive cycle was thus about twice that of 1938, taking the value of money into account. This represented a considerable effort, evidenced also by the fact that the percentage ratio of loans to deposits, which had been 63.6 per cent for commercial banks and savings banks at the end of 1938, rose to 74.4 per cent at the end of 1955.

In the absence of expansionary processes engendered by recourse to the Central Bank, the action of the commercial banks and savings banks, intense as it is both directly and indirectly on behalf of Italy's productive development, finds a limit in the volume of savings flowing to them.

Savings deposits of commercial and savings banks increased in the last two years by 18 to 20 per cent yearly, and in 1955 by 17.7 per cent; but these percentages, measured from time to time against the volume of deposits at the end of the preceding year, cannot tell us (in fact, they may confuse us) whether the annual increase in these deposits is in harmony with the rate of increase in income or what expectations are warrantable for the future.

Therefore, it appears preferable and, moreover, is of more general interest to see what part of the national income is not utilized directly for consumption or investment by the recipients of the income but is entrusted to the institutions which collect savings deposits, or employed on the capital market.

To do that, deposits at commercial banks and savings banks and post-office savings funds will be placed together, and funds invested in Government securities, shares and debentures of special institutions, and insurance premiums will be added; in brief, the annual formation of money savings will be considered, and related to national income.

To sum up the movements of previous years beginning with 1948, it is found that the accumulation of money savings has ranged between a minimum of 592 billion lire in 1951, which

was the year of monetary tightness following the outbreak of the Korean war and a certain race to stock up goods, and a maximum of 1,081 billion in 1955. This figure is compared with the average of 725 billion lire for the years 1948-49 which, as will be recalled, were the first two years of postwar monetary stability, and were not influenced by the course of the Korean war; the resulting increase proves to be 49 per cent. Net national product at current prices was 11,770 billion lire in 1955, against an average of 6,729 billion in 1948-49, the increase being 75 per cent. In other words, money savings, which were about 10.8 per cent of income in 1948-49, dropped to 9.2 per cent in 1955.

But in order not to give final weight to comparisons made between years marked by different economic trends, the period 1953-55 may be examined. The ratio in question then proves to have decreased from 9.8 per cent in 1953 to 9.6 per cent in 1954, and 9.2 per cent in 1955.

Both observation of a longer period and experience in more recent years indicate, therefore, that not only has no tendency been shown toward an improvement of the ratio between money savings and national income, but that the very opposite has occurred, though to a limited extent.

Conversely, the ratio between gross investment and national income has improved. Gross investment increased from an average of 1,406 billion lire in the two-year period 1948-49 to an average of 2,566 billion in the period 1953-55. The ratio of money savings to investment of 51.6 per cent in the two-year period 1948-49 thus dropped to 40.3 per cent in 1953-55. In the individual years of this last period, the ratio decreased from 43.8 per cent in 1953 to 41.4 per cent in 1954 and 36.9 per cent in 1955.

The phenomenon of an inadequate expansion of money savings, already revealed in relation to national income, thus proves to have broader dimensions when the comparison is made with reference to investment. The causes, to the determination of which the greatest interest attaches for the implementation of the measures necessary to carry out the ten-year program, are

not easy to isolate. It is true, however, that an important role is played by the level of consumption and the type of investments now prevailing among the sectors of the population from which money savings are largely drawn.

In 1954 the increase in private consumption had been 3.3 per cent; in 1955, coincident with a very large increase in income, it was 4.4 per cent. But in both years the percentages of increase in certain consumer goods sufficiently characteristic of those sectors were much higher than the average. In particular, purchases of durable household goods increased by 8 per cent and 5.5 per cent, respectively, but, above all, expenditures for the purchase and operation of private means of transportation increased heavily. At constant prices, these increases were 8.6 per cent and 15.8 per cent in 1954 and 13.4 per cent and 22.5 per cent in 1955.

The emphasis on these types of consumer goods cannot fail to have considerable influence on the volume of savings that flows to the credit institutions and the capital market in general. The spread of instalment sales has a large influence on the increase in the consumption of these goods, but it is difficult to evaluate these sales statistically because of the extreme variety of forms they assume in Italy.

In the field of investments, the importance of expenditures for the purchase of apartments in the use of income by those sectors of the population from which the most important contributions to money savings and the development of the capital market might be expected should be emphasized. In order to appreciate the scope of this phenomenon, it must be stated in the first place that in 1955 the large sum of 701 billion lire was invested in housing construction, which reached a new high with about 1,440,000 new units, or more than five times the annual prewar construction.

Concerning the dimensions of the capital market and in general of money savings, the conclusion may now be reached that the experience of recent years would not warrant the hope that they will increase in the future at a higher rate than that

of the growth of national income, so that the shift in the expenditure of income to investments, as intended in the ten-year program, should, in the absence of special stimuli, take place preponderantly in areas other than the money market.

The probability that such a shift toward productive investments will take place therefore depends on whether, in the implementation of the ten-year plan, consumption of certain consumer goods is moderated and, instead, a larger increase in productive investments is encouraged, with the use of appropriate instruments for achieving both purposes.

Government Finances.— Expenditure under the current section of the « administrative » budget for 1956/57 is slightly higher than 2,900 billion lire, according to the initial estimates. A comparison of this figure with that of about 40 billion lire under the 1938/39 budget shows a multiplication coefficient of about 73, which does not appear at all disproportionate in view of the coefficient measuring the increase in national income at current prices from the prewar period to the present time.

But comparison with the prewar, even to overlook the remoteness of the period of reference, cannot provide any useful basis for advancing any conclusions on the appropriateness of present expenditure. Therefore, these conclusions must be reached elsewhere, within the framework of the uses to which expenditure is assigned by the Administration.

Accordingly, useful elements may be drawn from a comparison between the present situation and that of six years ago, or more precisely, from a comparison of the budget for the fiscal year 1956/57 with that for 1950/51.

If expenditures covered with receipts derived from American aid are eliminated, it appears that the expenditures to be covered by domestic resources (taxes, income from property, and borrowing) rose between the two periods considered from 1,772 billion lire to 2,958 billion, an increase of 1,186 billion in the six-year period. Of that amount, 73 billion, or 6 per cent,

should be assigned to the category of investments (which rose from 390 billion to 463 billion), and 1,113 billion, or 94 per cent, is attributable to other categories of expenditure (public consumption and current transfers). Chief among these is the increase of approximately 440 billion lire going to active and pensioned public employees; equally important are the increases in the expenditure for war pensions of 106 billion, and expenditures for social welfare and relief, which increased by 73 billion, going to recipients from whom wide margins of savings cannot logically be expected.

It is indeed true that in the present state of our knowledge the final effects of Government expenditure cannot be determined with sufficient reliability since it cannot be overlooked that the so-called consumer expenditures lead, at least in part, toward increasing savings or improving the cultural level and the technical training of future generations, and are translated into an investment in human capital no less useful than capital in the form of economic goods, while the expenditures conventionally classified among investments might, in fact, be resolved into a destruction of capital and a waste of human labor.

Even with these reservations concerning the final effects of Government expenditure, there is no doubt that its development during the last six years has contributed to check the volume of savings which should be available to the economy for new production, and to the Treasury and other public entities for covering deficits.

It may be pointed out that the deficit for the fiscal year 1956/57 is not greater than that for 1950/51; it should be added that, looking at the series of deficits to be met with domestic resources from subsequent budgets, one might be led to the fallacious conclusion that if it was possible to weather without disruption the two years 1951/52 and 1952/53 when, according to the « administrative » budgets, the fiscal deficits to be financed with domestic resources were close to 500 billion and 600 billion lire, respectively, it should be quite easy to cover the present deficit, which is appreciably lower than those just indicated.

However, the analysis, to be relevant, should not be made on the basis of the « administrative » budgets, but on the basis of the cash requirements, which alone are important in terms of pressures exerted on the money market.

It should also be noted that in addition to carried-over balances properly so called, carried-over balances are formed that might be called improper, consisting in the immediate pouring back into the Treasury of budget payments. The final expenditures by the Treasury in favor of, for example, the Cassa per il Mezzogiorno (Southern Development Fund), did not by any means coincide in time with the dates of the budget payments; thus, the Treasury's position was improved by them in the first years of the Cassa's existence and made worse in more recent years.

As a matter of fact, the requirements to be met with domestic resources amounted to 240 billion lire in 1950 (the calculations on this subject are based on calendar years and not fiscal years), and were immediately reduced in the following year to 186 billion lire, with the result that on the average for the two years they were only slightly higher than 200 billion lire; however, in the last three years they have varied but little from 400 billion lire, i. e., they have almost doubled.

But these figures do not measure adequately the volume of the increased funds the market is called upon to provide as a result of the action of the public administration. The loans granted by the Central Post-Office Savings Fund from the savings deposits it holds, and the expenditures for new works made by the National Railways as extrabudgetary Treasury operations must also be considered.

For these purposes an amount of 49 billion lire was necessary in 1950 while 125 billion was required in 1955, an increase of 76 billion between the two years. But that is not all. Demands for funds on the money market by central or local public authorities or, in general, for financing works the cost of which is met by the Government in instalments or which are carried out only through the impetus of its contributions in

capital or in interest on the corresponding loans, cannot be omitted.

Thus, the pressure exerted on the savings market by the Government, directly or indirectly through its agencies, or even more indirectly with measures which lead public or private institutions to press upon that market, is now much greater than it was six years ago, whereas a comparison of the deficits of the « administrative » budgets alone might have led one to believe that it had even decreased. And since the private sector, doubtless partly through the impulse transmitted by greater expenditures of the Government and central and local public authorities, in turn needs larger amounts of capital, a capital stringency ensues which is clearly revealed by several indexes, of which the index of prices of Government securities shows directly the difficulties encountered in financing the deficit.

The difficulties found in providing the Treasury with the means it requires are also shown directly by the nearly constant volume of funds it manages to obtain outside the banking system. Despite the rapid increase in national income and in the dimensions of the capital market, these funds, including those used by the Central Post-Office Savings Fund for its financing and by the National Railways for extraordinary works, have ranged between 240 billion lire and 280 billion lire in the last four years.

Therefore, it becomes urgently necessary to repair the disturbed equilibrium, not only because it is a duty toward those who put their trust in the State, but also in order to make use of the most favorable financial conditions for redeeming the nine-year Treasury bonds which will fall due for several consecutive years beginning with the spring of 1959, now not very far off.

And it is also necessary to stop the practice of using bank reserves to cover the deficit. In fact, it might become necessary to return to those reserves, once and for all, their institutional function of counteracting possible inflationary movements.

Foreign Exchange Financing and Balance of Payments Problems.— As mentioned earlier, foreign exchange financing re-

quired the utilization of funds supplied by the Bank of Italy in the amount of 56 billion lire. This expenditure is closely correlated with the increase in the foreign exchange reserves during the year, which was equivalent to \$109 million. These reserves, in addition to increasing in size, improved in composition, an increase in free foreign currencies of \$196 million having been accompanied by an indebtedness to EPU of \$62 million and a reduction of \$25 million in the net balances on other accounts. These figures represent the final result of very broad movements.

Leaving aside the flotation on foreign markets of public and private loans and investments of foreign capital in Italy, the transactions with foreign countries usually classified as current increased considerably. Trade in goods, in particular, increased in 1955 in absolute value more than in any year since 1948, when for the first time since the war the economy was conducted under the sign of monetary stability. This increase was surpassed only in 1951, when world developments immediately following the Korean war and the general increase in prices led to an exceptional upward bound in the value of Italy's international trade, as well as in that of all other countries.

The annual increases in Italy's imports c.i.f. from 1948 to 1950 had been kept at about 40 billion lire. In the years following 1951 they were 105 billion in 1952, 53 billion in 1953, and 12 billion in 1954; thus, the increase in 1955 of 167 billion appears exceptional.

Imports of goods in 1955 amounted to 1,691 billion lire; this is twice the amount for 1948, which was 844 billion. On the average for the three-year period 1948-50 imports of merchandise were 885 billion; they rose in the recent three-year period 1953-55 to 1,576 billion lire, an increase of 78 per cent.

Since the national income at current prices increased between the two periods considered by 55 per cent, it appears that Italy's economic development, as shown in recent years, required an increase in imports of 1.4 per cent for each increase of 1 per cent in income.

A closer estimate for the period 1950-55, for which it was possible to prepare indexes of real variations in all debit items of the balance of current payments, produces an even higher value for the marginal elasticity of imports of goods and services in relation to income, of 1.7.

From these comparisons it is not desired to draw conclusions as to a « proportionality », so to speak, which can without qualification be considered valid for the future. However, it must be pointed out that the increase in imports in 1955 supports the assertion that the growth of consumption and investment rests on an increasing expansion of international trade. Exports also doubled in value from 1948 to 1955, with a more uneven course, however, which included the large drop in textile exports that took place after the peak in 1951; in 1953 and 1954 their growth was relatively higher than that of imports, with the result that they served to decrease the deficits by 22 billion lire between 1952 and 1953 and 70 billion between 1953 and 1954. Last year the percentage increase in exports also exceeded that of imports, but not sufficiently to reduce the deficit, which rose by 30 billion lire.

The ratio of exports to imports was about equal to that of 1948, slightly more than 68 per cent. Since the value of trade doubled between the two years compared, the trade deficit also doubled in absolute value. More precisely, it was 268 billion lire in 1948 and 530 billion in 1955.

Even if practically the entire increase in the deficit for 1955 over the preceding years is considered to be attributable to larger purchase of grains on account of the reduced home output in 1954, it must nevertheless be stated that the improvement registered in past years came to a halt.

In brief, it can be said that the accounts relating to food-stuffs, the so-called auxiliary materials (coal and mineral oils), raw materials, and metallurgical products deteriorated heavily, while there was considerable improvement in engineering products, textiles — especially because of a decrease in imports of natural fibers — and numerous miscellaneous export items, consisting in general of products of medium and small industry.

The average increase in agricultural production in the last two years has been estimated at about 22 per cent over the average for the four-year period 1936-39, which is usually regarded as representative of the prewar situation; with the increase in population that has taken place in the meantime, the increase in production per capita is about 10 per cent. In spite of that, the foodstuffs account, in constant prices (1955), changed between the two periods from a surplus of 63 billion lire (excluding the colonies: 34 billion lire) to a deficit of 40 billion.

The most important progress made during the year was in the engineering sector. Not only were imports, with 225 billion lire, slightly below those of 1954, but exports increased by upwards of 53 billion, or 26 per cent of exports in 1954, which amounted to 202 billion lire; thus the engineering products account became favorable for Italy once more.

These remarks on Italy's foreign trade cannot be concluded without calling attention to another favorable note. Exports to the dollar area increased by about 25 per cent in 1955, and this percentage not only considerably exceeds the average increase in our exports, which was 13 per cent, but is also the highest among the Western European nations after Germany's barely larger increase.

The trade deficit which has been briefly analyzed, if measured as a residual balance between imports f.o.b. and exports, proves to be 409 billion lire. It was covered, for 64 per cent, by the net proceeds of tourist travel (119 billion lire), workers' earnings and emigrants' remittances (78 billion), and by the balance of minor debit and credit items (67 billion). The amount that remained to be covered thus came to 145 billion lire, equivalent to \$233 million. This represents a contraction of the deficit in relation to 1954, which closed, in adjusted figures, with a deficit of \$290 million; the improvement of \$57 million, however, was less than that registered in 1954 (\$60 million).

This persistence of a considerable deficit was not unexpected; rather, precisely because of it and the decline in American aid, Italian institutions and businesses had for some time been floating loans abroad.

Even at the present stage, however, American aid has still contributed to the balance of payments 23 billion lire in 1955, as have earnings for offshore purchases in the amount of 81 billion lire and other minor items for 21 billion.

Capital movements (proceeds of loans contracted abroad by Italian institutions and businesses, investments in Italian securities and in various enterprises on the part of foreign countries, use by Italian banks of lines of credit and foreign exchange derived from deposits, and, lastly, increases in commercial debits and credits), caused an inflow of foreign exchange in the amount of 89 billion lire.

From these movements, taken together, there was an increase in official foreign exchange holdings of 68 billion lire, equivalent to \$109 million, as already mentioned.

This increase does not warrant less vigilance for the future.

In the first place, it is a good rule that a larger volume of foreign trade should be accompanied by an increase in foreign exchange reserves, which have the specific function of protecting its growth by absorbing its variations, which are always difficult to foresee, and which may be the greater as trade increases.

In the second place, analysis of the balance of payments shows that more than half of the increase in foreign exchange holdings during the year was due to an increase in indebtedness at very short term, demand obligations, so to speak, in the international relations of Italian banks; this was permitted in order that use might be made of less onerous interest rates than those at home, but, by its very nature, it does not have a stable character.

Hence Italy is still faced with the problem of the forthcoming termination of American aid and earnings for offshore orders.

Finally, even if the expectation of an increase in invisible items is warranted, considerable efforts are still required to reduce the trade deficit to reasonable proportions. The aim should be to secure that result gradually along with the growth of consumption and investment, so that success will be

achieved only with the avoidance of excesses in either direction; i.e., by not allowing consumption and investment to rise excessively, and not attempting to eliminate the present deficit at a single stroke.

Partly because of this cautious policy, international circles are following Italy with the greatest sympathy, disposed to aid in the solution of the problems of her economic development, assured by the proofs of balance given and by the efforts made throughout the postwar years, now not a brief period.

The International Bank for Reconstruction and Development, in particular, is considering with great sympathy, for which Italy is truly grateful, the possibility of increasing and extending the credit already provided for the development of the South.

Prices.— In 1955 there were no important symptoms of the existence of inflationary pressures. The increase in the indexes of fiduciary currency and bank money developed normally, and, in some industrial sectors producing goods for current consumption, inventories decreased. Increases in inventories took place principally in the agricultural sectors, as a result of the considerable output of grains, in the sugar industry through the increased production of sugar beets, and in the engineering industry on account of the increased load of orders. But inventories of this type do not indicate the speculative stocking-up of goods that usually accompanies manifestations of distrust in the currency.

The capital market, especially for part of the year, showed an increase in the price of shares and, particularly towards the end of the year, a decline in the prices of Government securities. In regard to the first movement, however, it appears sufficient to point out that productive activity developed during the year at a rather intense rate in many sectors, in a period of increasing income; in regard to the second, it has been pointed out that the national budget has shown in past years, even with increased public expenditures, a certain contraction of the « administra-

tive » deficit. And if that was not sufficient to prevent the decline in the prices of Government securities, the reason must be sought in the Treasury's persistent calls on the market for funds, which have been made year after year without interruption, and are in competition with the requirements of the private sector.

Finally, examination of the current accounts of the balance of payments shows that even that deficit tends to improve, a circumstance which can hardly be reconciled with the existence of inflationary pressures, according to the experience of Italy and other countries.

To complete the picture, the behavior of prices remains to be considered.

According to the index of the Central Institute of Statistics, wholesale prices showed a very slight increase of 0.3 per cent between December 1954 and December 1955, against an increase of 1.8 per cent between December 1953 and December 1954. These changes from one December to the next would indicate therefore that 1955 was on the whole better than 1954 in regard to the movement of wholesale prices.

But there is more. If the first nine months of the year are separated from the last three, the wholesale price index of the Central Institute of Statistics shows a decrease from December 1954 to September 1955 of 1.4 per cent. The dip in prices of domestic foodstuffs — also of 1.4 per cent — and the more remarkable decrease in textile materials and products, as well as in hides and footwear, more than neutralize the increase that took place in other materials utilized by industry, especially in the group of metals and in fuels and building timber.

Although held within narrow limits, the drop in foodstuffs, which had been about 8 per cent on the international market, still represented a factor of considerable importance in Italy's situation.

In the Report for last year the drop in Italy's industrial prices in 1954 had in fact been pointed out, and concern was expressed that it had been offset, or rather exceeded, by the movement of prices of foodstuffs, which had been increasing in Italy

in recent years, in contrast to the trend on the international market.

Unfortunately, in the last quarter of 1955 the index of food prices again began to rise, both for foods of vegetable origin and those of animal origin, while the upward movement of fuels and other industrial materials continued. Nevertheless, the year closed, as already indicated, with a wholesale price level practically equal to that of 1954.

To judge more fully the year just ended, reference must be made, finally, to the encouraging capacity of Italy's industry, as shown for years past and strengthened in 1955, to absorb, fully or in large part, the increases in prices of raw and semifinished materials in the course of the transformation process. Indeed, the general index of manufactured products went down slightly in 1955, despite the fact that the prices of raw and semifinished materials were on the rise and, as is well known, wages also tended to increase.

This is a manifestation of the remarkable improvement in productivity that has taken place in industry, facilitated, it is true, by a growth in demand on which Government expenditure, especially expenditure for the South, has had considerable effect, but which got its real start from liberalization.

These observations on the behavior of wholesale prices during 1955 seem to warrant the conclusion that there was no inflationary pressure, even on this side, of any importance.

The situation has been aggravated not a little, however, in the first months of 1956, principally because of the severe frost which reduced the output of vegetables and fruits.

The prices of foodstuffs which, as already pointed out, had shown a slight dip in the first nine months of 1955, rose 6.6 per cent in the next six months (these observations conclude as of March 1956). Thus, the general index of wholesale prices, which had dropped 1.4 per cent in the first nine months of 1955, rose 2.9 per cent from September to March.

In this six-month period, not only have food prices increased, but also, in sympathy with the international situation, the prices of some important industrial materials have continued upward, and prices of some textile raw materials have recovered, the result being that the movement of Italian agricultural and industrial prices, rather than offsetting each other, have combined their forces.

The cost of living index rose 3 per cent from December 1954 to December 1955. For purposes of appraising the year 1955, it should be noted that the increase during the year was lower than that which occurred in 1954 (3.6 per cent), and that almost one-third of it was due to an increase in legal rents.

But even in regard to the cost of living, the situation has deteriorated considerably in the first months of this year.

The effect of another increase in the housing component following the new increase in legal rents that became effective January 1, was supplemented by the heavy influence of food and vegetable prices, which reached extremely high points as a result of the heavy frosts.

As of March 1956, the index of the food component was 6.0 per cent higher than that of March 1955 (olive oil showed an increase of 81 per cent), and the general cost of living index, which has risen 3 per cent from December to December, increased by 6.4 per cent.

Perhaps attention should be drawn again to what has been said for years at this meeting concerning the heavy effect on wages of the too rapidly automatic mechanism that regulates the functioning of the sliding wage scales, or escalator clauses. The influence exerted on the cost of living index by the seasonal nature of vegetables and fruit, which are on the rise from March to June and on the decline in the second part of the year, has been pointed out on several occasions. Naturally this seasonal movement would not have any disturbing effect if the prices used for constructing the index did not serve as a basis for the functioning of the sliding scale mechanism. Other conditions remaining equal, the index would only show alternating movements.

But that is not the case. In fact the seasonal upward wave causes the sliding scales to rise, leading to an increase in the volume of wages; this produces an increase in the demand for goods of all kinds which pushes their prices upward, so that the subsequent downward seasonal wave in the prices of vegetables and fruit becomes part of price level already increased and sustained by the additional money demand, and therefore cannot restore the previous situation.

The short supply, determined by the causes already indicated, on the market for olive oil and vegetables and fruits in the first months of the year in progress drove the prices of those goods upward, some of them even being tripled, and has necessarily reduced consumption to a very large extent. Now, the mechanism of the sliding scale has continued to function on the erroneous assumption that consumption of those goods is continuing at the same rate as before. Wages in industry consequently increased by 2 points beginning in April and will increase by 4 more points beginning in June, and similar movements have taken place and will take place in other sectors.

It was not by chance that the system of the sliding scale was originally introduced everywhere in periods of monetary instability to cope with exceptional needs for protecting the purchasing power of employed persons. Thereafter its use was continued and consolidated even in less disturbed monetary periods, when, however, the imperfections of the system make its application dangerous since the minor changes characteristic of these periods may be dominated by seasonal factors and by the faulty methods of compiling the price data.

In the presence of changes of sufficient breadth and duration, the system might still be used without serious damage, but in every case an effort should be made to keep a permanent increase in wages from being linked to temporary factors or to weather conditions, and especially, to a malfunctioning of instruments which amplify the real scope of the changes.

Sliding scale systems should at least be regulated in such a way as not to function in only one direction, and should therefore

be surrounded by indispensable safeguards, such as reference to average values extended over sufficiently long periods and the introduction of margins of tolerance for changes in both directions.

After what has occurred, foreigners are probably astonished, among other things, that in Italy none of the measures which other countries have used to combat inflationary pressures have been adopted or are being adopted: raising the cost of money, credit restrictions, increased taxes, elimination of customs barriers, reductions or postponement of investment plans, etc.

As a rule, the adoption of these measures has not preceded the attainment of full employment. Only when, as the limits of the productive system's capacity are approached, the difficulty of a further adaptation of supply to an expanding demand becomes clearly evident, is an effort made to check demand or to bring it back to lower levels with general measures which, although pervasive in scope, primarily affect the demand for investments. In Italy, the productive system showed throughout 1955 its adequacy to satisfy demands within a framework of stable or moderately increasing wages and growing employment, in which considerable profit margins utilizable for investment were obtained. Only at the end of the year, as has just been shown, did some signs of tightness appear in parts of the food sector. The more obvious excess demand that occurred for certain food items in the following winter months, being the effect of an accidental reduction in supply, was not of such a nature as to justify the adoption of restrictive measures of a general character which principally affect investments. The appropriate remedy might have been found in a manipulation of imports or inventories if the disturbance of supply had involved nonperishable or import commodities rather than perishable or export commodities for which possibilities of manipulation were nonexistent or less flexible.

The Government ten-year development program, after having assigned to the unemployed to be absorbed into production a volume of consumption on a par with that of the employed,

found that for those now employed there remained the possibility of increasing their income by about 30 per cent in the decade. That means an annual average increase of 2.6 per cent. Now, last year the increase in consumption was 4.4 per cent.

This apparent deviation can be explained in only one way, i.e., by the exceptional increase in real income in 1955.

In particular, the disparity between the crop years 1954 and 1955, the one of shortage and the other of abundance, played an important part. However, in view of the damages suffered by the crops because of unfavorable weather, it can be assumed that the outcome of the agricultural year now in progress will serve to reduce the average increase in national income and place it below the increase that may be found in industry.

Consequently, on the basis of elements now available, it appears difficult to count on a higher increase in real terms in the national income for 1956 than that envisaged in the ten-year plan. Therefore, this year it will be more necessary than ever to put into practice the principles on which the ten-year plan is based, and specifically to check the expansion of consumption decidedly if it is desired to maintain a high rate of investment.

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In 1952 the large volume of liquidity left to the market, which permitted the initiation of numerous productive projects encouraged by the greater expenditure in the South, led Italy to watch with some anxiety to see what dimensions would be assumed by the unfavorable manifestations that generally accompany a phase of rapid growth.

The heavy deficit occurring immediately in the balance of payments and correctly not offset by the use of quantitative restrictions which would have pushed domestic prices upwards, was financed principally with American aid, which was once more as valuable as it had been indispensable in the previous phase of reconstruction.

At that time we were confident that the deficit would subsequently be reduced, and that our foreign exchange reserves would not undergo losses which would compel us to renounce perhaps for many years any hope of solving our development problems. And that confidence was fortunately encouraged by the facts, for the deficit was gradually reduced, and the foreign exchange reserves, although following a course considerably below that of other European nations, were nevertheless adequately safeguarded.

Therefore, we have reason to believe that Italy can achieve a firmer and better equilibrium, if only the will to achieve it and the capacity to accept all the necessary sacrifices are present.

Despite certain contrary appearances in the indexes of some prices, which have recently moved for merely fortuitous reasons, the conviction appears warranted, and an attempt has been made to show, that this stability is still adequately maintained, given the absence of those underlying movements that usually develop during an inflationary process.

However, certain apprehensions have not been concealed, and from them reason has been drawn to show the need for proceeding with caution in the further development of economic action and, above all, for keeping a steady eye on the behavior of our foreign trade.

Excessive spurts of certain types of consumption or certain types of investment, now more than ever, are likely to expand imports or to contract exports because, as a result of the high level attained in the utilization of material resources of internal origin, the influence of the foreign component in our economy has increased.

Nor, to moderate these effects, are protective practices feasible, whatever form they may assume and whatever may be the reason advanced for invoking them. These practices, in one way or another, sooner or later, are paid for in the general level of prices, so that the reduction of imports which may arise from them ends with an induced decrease in exports and merely retrogressive effects on economic development.

Problems of monetary stability are on the first level of importance throughout the Western world, which has progressively banished policies that are detrimental to monetary stability or that preserve it in only a fictitious and therefore precarious way. The effort the various countries are making is to preserve stability in an environment increasingly freed from the limitations and restrictions which had multiplied, especially in the field of international trade, during the decade preceding the war, and had survived at the end of the war, becoming intensified at times to overcome the grave problems of reconstruction.

Italy has been traveling determinedly along this road for a long time, occasionally assuming vanguard positions. Her pace must be quickened lest she be left behind in the process of liberating both trade and currencies from the shackles that still bind them. The progress achieved and the present state of Italy's monetary relationship with foreign countries seem to justify the assurance that broader results can be achieved here also; thus, the hope appears warranted that Italy will continue to be an active element in the development of international cooperation in the years ahead.