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Excerpts from the Governor's Concluding Survey

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

Gentlemen,

I should like now to give you a brief survey of the past year—a year in which the economic climate underwent a profound change and, as a result, our Bank was faced with tasks of great responsibility.

World Economic Conditions and Monetary Policy.— The symptoms of recession or stagnation have now disappeared everywhere, though they did not do so in all countries at the same time. They have given way to symptoms of an intense revival of economic activity, and indeed often of boom, to counteract which many countries adopted last year a series of monetary and also fiscal measures.

In Europe generally, the balance-of-payments situation improved and some countries registered large surpluses. The United States balance of payments, which had undergone significant deterioration accompanied by an unwonted outflow of gold, is now gradually recovering and the position of the dollar has strengthened once more.

The U.S. government and monetary authorities knew how to keep calm without remaining idle. They did not shirk the sacrifices entailed by balancing the federal budget and imposing counter-cyclical measures; while thus focussing their attention on the basic problems of domestic economic order, they also appealed to international co-operation, with a view chiefly to a rapid and progressive elimination of discriminatory restrictions against dollar imports and to a more balanced distribution of aid to underdeveloped countries.

At the close of last year the western countries could look forward to new and sizable advances in their income levels.

The sense of caution and watchfulness which, already in 1959, inspired the economic policy of most western countries is fully in line with this prospect. Even the most determined expansionists now concede that the revival which started last year and still continues has largely taken up the slack of unused productive capacity and surplus labour which existed in many countries. It follows that if these countries are to avoid inflationary pressure they can afford additional demand only to the extent that their productive potential may grow in time by the sole virtue of greater investment and movements in the labour force.

In Great Britain the number of vacant jobs has been increasing since the beginning of 1959; over the country as a whole the number of vacancies is now almost equal to the number of unemployed and in the two most important industrial areas is already greater. In Germany job vacancies have been in excess of applicants since the summer of 1959 and the labour shortage has become a limiting factor especially in the building industry. At the end of the year the number of unemployed was less than 1 per cent of the labour force.

In both countries the marked tendency to shorten the working week is imposing further limitations on the productive potential.

Much the same situation exists in some of the smaller countries, such as Switzerland, the Netherlands, Sweden and Denmark.

France, too, has full employment, but in that country immigration, the shift of workers away from agriculture and the lengthening of the working week have so far limited the strain on the labour market.

In other countries the strain on the labour market began, from mid-1959 onwards, to accentuate the tendency towards an increase in wage rates, and particularly in wages actually paid over and above contractual rates—a typical feature of periods of intense demand for labour.

Each country's balance of payments was protected from the adverse effects of expanding domestic demand by the simultaneous expansion of demand in many other countries. Only in

Great Britain was the revival accompanied by a deterioration in the balance of payments. In Germany and in the other continental countries the balance of payments on current account remained substantially in surplus, so that it should be possible to relieve the pressure of home demand by a transfer of resources from exports to the domestic market.

The situation in Great Britain clearly called for a containment of domestic demand. The measures so far adopted to this end have mostly been designed to combine the general effects of demand contraction with a deflection of demand into less inflationary channels.

The choice of economic policy is less painful than in Great Britain but also less clear-cut in the other kind of situation where the balance of payments is in surplus but wages and prices are set to rise, because the total money demand for consumption, investment and net exports tends to exceed resources. In such a situation measures to restrict domestic demand (such as an increase in compulsory reserves or the raising of the discount rate) would tend to perpetuate the export surplus and to attract foreign capital, and so to increase the country's liquidity in two ways. If, on the other hand, the authorities allowed existing liquidity to promote an expansion of domestic demand, the foreign surplus would fall but the transfer of resources from exports to the domestic market would inevitably occasion some price increases. At the root of the dilemma, which presented itself in a rather acute form in Germany during the last few years, is the existing regime of fixed exchange rates combined with as yet insufficiently co-ordinated national economic policies.

The monetary authorities of many countries have become newly aware of one particular problem which had already arisen during the inter-war period. I have in mind the problem of the connection between the structure of interest rates and international capital movements and of the possibly conflicting internal and external effects of any action on interest rates. An inflow of capital attracted by higher rates of interest may, in fact, not only impair the effectiveness of internal restrictions but also weaken the foreign exchange reserves of third countries to the point of inducing them in their turn to raise interest rates so as to defend their own external liquidity.

In order to mitigate undesirable external effects of this kind, there is a growing tendency to regulate the volume of demand via the banking system's liquidity rather than by changes in Bank rate.

The problem cannot, however, be evaded altogether, because the liquidity situation itself affects the level of interest rates and the level of interest rates affects capital movements. For example, a certain reciprocal adjustment of comparative interest rates has already come about as a result of British and U.S. restrictive monetary policies and of the capital movements following upon the introduction of convertibility; given the narrower yield spread, foreign investors have also reduced their purchases of the securities of other countries.

Altogether, governments are tending towards compromise solutions between full autonomy of national economy policy and full integration into an international system of exchange of goods and capital, which would entail a levelling-out of interest rates. In other words, it seems likely that governments find it useful, especially in the present situation of international liquidity, to keep in hand some power of control over capital movements and at the same time to align economic policy with the requirements of international co-operation.

Let me now turn to countries outside western Europe. As regards the United States, it has to be remembered that during the first few months after the steel strike production was stimulated by the rebuilding of stocks. Once this initial stimulus had spent itself, and in the absence of other equally vigorous sustaining factors, the expansionary impetus slowed down.

The demand for durables, which in Europe represents the most dynamic component of consumer demand, suffers in the United States from the existing wide diffusion of this type of goods. Building activity is declining in comparison with the first phase of recovery, when it was encouraged by easier credit facilities. New fixed investment is, in the United States, conditioned more by the requirements of technological progress than by lack of productive capacity. In particular, the two sectors of steel and motor vehicles, in which Europe is carrying out or planning massive investment, are in the United States characterised by reserves of unutilised capacity in relation to present levels of activity. The slowing-down of activity was reflected, during the first four months of this year, in an appreciable fall in market rates of interest and in a more lenient attitude on the part of the monetary authorities. The sense of moderation with respect to pricing and wage negotiations, with which the recent conflicts seem to have imbued both firms and trade unions, permits the hope that economic expansion in the United States may continue without aggravating the balance-of-payments problem.

Finally, the underdeveloped countries were, on the whole, able to improve their balance-of-payments position in the course of 1959; their higher reserves, the continuous inflow of capital from industrial countries and the satisfactory level of demand for primary products would lead one to expect that these countries will register further substantial advances during the current year and that their imports will help to sustain activity in the supplier nations, of which Italy is one.

Economic Conditions in Italy.— The whole western world, as I have recalled, witnessed during the last two-and-a-half years first recession or stagnation and later a brisk revival, which has lifted the index of industrial production nearly everywhere above its 1957 levels; but Italy registered greater progress than the industrialised countries of western Europe and America.

As I already had occasion to observe at last year's General Meeting, the pace of development slowed down less in Italy after the 1957 turning point, and subsequently we benefited from a more pronounced recovery, as present figures prove.

Last March our index of industrial production, corrected for seasonal variations, stood at 178 (1953 = 100) and was thus some 26 per cent higher than in September 1957. This means that if from that time onwards our industrial production had expanded uninterruptedly at the rapid annual rate of, say, 10 per cent—which would have been more than the rate of roughly 8 per cent at which expansion has proceeded since 1953—we would not have attained a higher level than we actually did.

The rate of development between December 1958 and December 1959 reached 17 per cent; more recently, between July 1959 and March 1960 (for eight months running) production increased at the extraordinarily high compound rate of 2 per cent per month, and indeed nearly 3 per cent in the investment goods sector, where the special influence of developments in the iron and steel industry and in engineering was most marked.

I must, however, add at once that our greater progress is, basically, to be explained by the fact that expansion was handicapped neither by a labour shortage, such as existed elsewhere, nor by the kind of measures other countries adopted to combat the inflationary pressures mentioned.

It is true that our country, too, suffers from certain limitations in the supply of skilled or at least properly trained-labour, but we in Italy still find it less difficult than other countries to increase the number of employed workers, especially in public works and building but also in the less skilled jobs in industry.

In its spectacular recovery our industrial production had the advantage of the climate created by a high level of activity in the public works sector, which in 1959 consolidated its 1958 results and even improved upon them. It also had the advantage of the prospect of greatly increased public expenditure by virtue ol Law No. 622 of last July, the implementation of which was assured by the success of the 300 billion lire loan floated that same month.

Another factor which helped to swell effective demand was residential building, especially on public account. While the rate of expansion in that sector was lower in 1959 than in the years 1953-1957, when it was well in excess of the rate of increase of national income, it was still high enough to make this sector register an increment of 7 per cent over the whole of 1959, compared with 3.5 per cent in 1958.

But, over above the recent growth of private investment, a major and, in certain respects, decisive contribution to the vigorous revival which we have been and still are witnessing came from foreign demand, which increased considerably in the course of 1959—especially during the last six months of the year—and in the first few months of this year.

In the food sector the volume of fruit and vegetable exports increased significantly in response to foreign demand, but, owing to the price fall due to the abundant crops, total export earnings in 1959 were not appreciably higher than in the preceding year. Nevertheless, we were able to avoid the damage which agriculture would have suffered from a real collapse of prices such as the higher output would certainly have caused if it had not been accompanied by larger exports.

But it is above all in industrial products that we had an export boom, especially since last July.

The volume of exports of manufactured goods during the second half of 1959 was 41 per cent above that of the second half of 1958, and in the first quarter of this year was 49 per cent above that of the corresponding period last year.

The most conspicuous part of the increase is to be attributed to the sharp expansion in textile exports, after some important branches of this sector had gone through many years of crisis, as well as to the notable advances in the export of engineering products, especially motor vehicles. Both were connected, though in different measure, with the general improvement in economic conditions in the industrialised countries of Europe and America after the phase of recession and stagnation in 1958, and both were, above all, manifestations of that general process of integration among the countries of western Europe, and especially of the Common Market, in which our country is successfully finding its place.

Finally, the conflict which, as I noted at the beginning of this survey, arose in some countries between domestic and foreign demand, also worked to the advantage of our exporters, who were able to cater to the increased foreign demand without delays or limitations.

Thus Italy was able in 1959 to score a winning point in the contest for expanding exports which has developed among the industrialised countries since the last war.

In fact, the volume indices of merchandise exports computed by the Commission of the European Economic Community show that, taking 1953 = 100, Italy's index rose as high as 270 during the last quarter of 1959 and overtook even that of Western Germany.

Production and the Balance of Payments.— At last year's General Meeting, mindful of the need to widen the domestic market and to expand foreign trade, I felt it right to state openly that a further investment drive in the public sector should be favoured. I made the point that this would not hamper but, on the contrary, would stimulate the revival of private industrial investment and that both kinds of investment could be effected without serious danger of inflation, given the sound balance-of-payments position we had achieved and provided only that the rate of increase of wages remained moderate.

I now feel it incumbent upon myself to state my view on the question whether our present investment drive can be sustained, as I predicted last year, without seriously impairing the defences we have built up in the foreign exchange and monetary fields.

We have for some months been witnessing a considerable increase in imports. According to the trade returns, the volume of imports rose by only 11 per cent between 1958 and 1959; but in the first quarter of 1960 imports of the most important industrial raw materials were, in terms both of volume and value, as much as 40 per cent higher than in the corresponding quarter of last year, and total expenditure for imports rose even more, namely by 50 per cent.

In absolute figures, the deficit as between imports (cif) and exports rose considerably over the last twelve months: it was 85 billion lire in the first quarter of 1959 and 175 billion in the first quarter of this year. Thus the deficit was 90 billion lire higher, and if the same thing should happen for the rest of the year, the overall deterioration in the results of 1960 compared with 1959 would be as much as 360 billion lire, or just under 600 million dollars.

On the basis of these calculations, the deterioration would still remain within the limits of the surplus which the balance of payments on current account registered in 1959 and would be only slightly in excess on the analogous surplus in 1958.

Our deficit on merchandise (fob) account amounted to 373 million dollars in 1958 and then fell to the exceptionally low level of 125 million dollars in 1959; but these deficits were amply covered by the net surplus in respect of invisibles, which was approximately the same in the two years (835 million dollars in 1958 and 814 million in 1959).

Should the above inductive calculations be confirmed by facts during the coming months, our more active investment policy, the rebuilding of stocks and the increase in consumption which always accompanies a phase of expanding output would not exert pressure on our balance of payments beyond absorbing the 1959 surplus on current account and would therefore be compatible with the maintenance of equilibrium or even a modest surplus in our current balance.

Thus the balance of payments on current account, which showed large surplus during the last two years, is now tending to return to equilibrium; but although the calculations which seem legitimate at the present moment suggest that the previous surpluses must be expected to diminish sharply, there is no need to conclude that they have already disappeared or, worse still, have turned into a deficit.

We should, in this context, not be misled by the fact that the Banca d'Italia's credit balance with the Italian Exchange Office has been falling since last December (by 89 billion lire between December and April) instead of rising as it had done before for many months; we need not conclude that the worsening of the balance of payments on merchandise account is making inroads on our reserves.

The reduction of the credit is, instead, connected mainly with a provision adopted last November, by virtue of which part of the reserves has, since that month, been left at the disposal of authorised banks with a view to enabling them to reduce their substantial short-term foreign indebtedness.

If this is taken into account, it will be seen that during the first four months of this year our net foreign exchange reserves changed from 2,506 million dollars to 2,525 million (provisional figure). Thus our reserves did rise further, if only slightly, and during the winter months at that, when tourist earnings are at their lowest level of the year and when certain seasonal supplies require expenditure which does not have to be repeated in subsequent months.

It is, then, mainly to the development of our current balance that we must look in trying to assess the effects of our expansionary policy on our gold and foreign exchange reserves; and, as we have seen, from this point of view present figures suggest that the reserves ought not to diminish in the near future, or at least that any diminution should not be lasting, and that, in any event, any curtailment our reserves may suffer should not be such as to reduce them below the limits of safety.

To raise our reserves to a level high enough to permit us to face emergencies, we did not hesitate in recent years, when circumstances were favourable, to contract large medium and long-term debts abroad. We deliberately shouldered this burden and defended our reserves against any suggestion to use them, leaving Italian capital entirely free to be invested abroad; and we did so mainly in order to meet precisely this situation of larger imports which the growth of domestic investment and consumption could be expected to create and has in fact created. And if I advised against any excesses in the rate of expansion of consumption, it was always in order to provide a sound base for an active investment policy, both in the public and private sectors, such as is now being pursued and seems destined to become even more firmly established in the coming months.

We are beginning to reap the fruits of our consistent policy, in that we need not have recourse to restrictive measures at the moment when the balance of payments inevitably reflects our efforts to strengthen our productive structure and the amenities at the service of ordinary life in our country.

Restrictive measures of a serious kind would, however, become necessary in the unfortunate event that the prices of imported raw materials should rise or that some materials should become altogether unprocurable or be rationed, as happened at the time of the war in Korea and of the Suez incident.

We would likewise have to resort to restrictive measures if we failed to prevent an autonomous rise in domestic prices, which would also have serious effects on our balance of payments.

Having said this, I should not like to be misunderstood. Last year I encouraged a policy of increased public investment and stated my view that our balance of payments could well stand such a policy as well as a revival of private investment; now I can point out that my prediction has been proved true by the figures currently available. But I did not mean to imply then, and do not mean to imply now, that there are no limits to our resources, or worse, that we are absolved from the duty to make the most expedient and least expensive use of these resources; nor can we afford to cease keeping a careful watch on the course of events which might jeopardise the equilibrium we have achieved.

Indeed, we still have to face enormous expenditure in all directions if we are to give the poorer sections of our population a standard of life which lifts them above indigence and if we are to make sure that they can fully satisfy their elementary needs and receive better education.

In the light of these requirements, we come to realise how small is the margin which our balance of payments still leaves us for more far-reaching measures to expand investment and consumption.

For this reason we must in the future concentrate our efforts especially on an adequate increase in our export potential.

I believe that, while much has been done in this respect, much more still remains to be done.

In actual fact, a profound transformation has, in recent years, taken place in our productive apparatus, not least through the introduction of significant technical innovations. The design and construction of new plant have been both improved and speeded up, thanks to the widespread contacts which Italian entrepreneurs and managerial personnel maintain with the most experienced groups abroad.

Foreign firms are establishing themselves in our country, because, *inter alia,* they wish to gain a foothold in the Common Market and are attracted by the relative abundance of labour here; this, too, is a contribution to the growing efficiency of our productive apparatus.

For these reasons, and because our foreign exchange reserves are now strong enough to permit us to buy even abroad the best equipment to be had in the present state of international technology, many of our old-standing disadvantages have disappeared. Even the cost of capital, which was not the least of the causes of our inferior performance in the past, has now come very much closer to that prevailing in other great industrialised countries.

Finally, in recent years the training of the young people destined for leading positions in business has made another signal contribution to the improvement of our productive efficiency. As the war years receded, training became more thorough, and we have now reached the stage when a new generation of sound technicians is taking its place in firms which had for many years been cut off from the progress of knowledge achieved elsewhere, especially in America.

The radical renewal of our industrial equipment, the considerable investment we are making in certain capital intensive sectors and also the process of mechanisation of agriculture, explain the significant divergence between the overall increase in output shown in the statistics and the relatively smaller increase in the numebr of persons employed in the productive process.

We all share the desire to reduce to a minimum the time which still separates us from the moment when the level of unemployment and underemployment in our country should become less patently different from that in more developed industrial countries, and this desire has led some of us to advocate a slowing-down or restriction of investment in sectors which, in the nature of things, can make only a small direct contribution to higher employment.

This is no doubt a principle inspired by generous motives, but its exclusive or predominant application to the economic choices our country has to make would no longer be in full accord with the evolution of the domestic and international economic climate during the last few years. The growing freedom of international trade compels us more than ever to maintain our competitive ability, so as to be able to finance that vast stream of imports which is one of the fundamental elements of our productive expansion. Our general watchword must be efficiency, and exceptions are admissible only to a limited extend and in well-defined cases of grave social necessity which cannot be met by other means.

To conclude, it is my belief that we can achieve durable results in the fight against unemployment by introducing all those innovations which enable firms to reduce production costs. Producers should take advantage of these cost reductions to go on increasing the volume of their sales and we should be more energetic in eliminating any practices which might tend to impair competition domestically and internationally or to keep prices artificially high.

Especially the expansion of exports, I repeat, depends closely upon our ability to produce at competitive costs. This applies more particularly to the more highly processed goods. Owing to the relative decline in textile and agricultural exports the main burden of sustaining our balance of payments has in fact already shifted to types of production which, to be successful, must be based strictly on the adoption of the most refined techniques and on efficient and economical business organisation.

Finally, careful attention should be devoted to efforts to increase also our receipts from the invisible items in the balance of payments, which constitute a no less important contribution than the receipts on merchandise account. This applies especially to tourism.

Price Movements.— From a monetary point of view, we had a climate of reasonable stability last year.

The annual average of wholesale prices dropped 3 per cent in 1959 in comparison with 1958, and between March 1959 and March 1960 the general price index rose by no more than 1.5 per cent, having already absorbed the 1.8 per cent rise in agricultural prices.

The considerable expansion of output which we are experiencing has, therefore, at least so far, not exerted any significant pressure on the price level.

Nor has the cost-of-living index shown signs of any basic strain. The index did go up by 2.6 per cent between March 1959 and March 1960, but about three-fifths of the rise are to be imputed to housing expenditure, which reflected the recurring increase in blocked rents.

There is no doubt that the situation needs careful watching.

We cannot in the future, any more than in the past, evade the consequences of any hardening of prices, especially of raw materials, on the international market—of which, incidentally, there is at present no sign; but we must at all times, and especially at times of expanding production, avoid autonomous price rises at home.

The investment plans of government-controlled and private companies are certainly very ambitious and the volume of their investment will be a good deal larger than even in the best years of the post-war recovery.

Similarly, there is no precedent in the whole of our economic history for the high levels to be reached during the next few years by public works expenditure as a result of the large credits appropriated in 1958 and 1959 by the Central Post Office Savings Fund, by the even higher expenditure to be incurred by the government in implementation of the extraordinary programme to be financed by last year's 300 billion lire loan and the Finance Act 1960/61, and finally by the expenditure necessary to carry out the " Green Plan ".

Thus aggregate demand, which had already risen considerably during the last eight to ten months, is tending to grow further, and if the effects of the expansion of demand are not to be sharpened all-round moderation is called for.

Another danger which readily appears in times of high production is that of cost inflation. We could neither have enjoyed price stability nor achieved the progress we did in many fields, especially in exports, had it not been for the fact that wage increases, especially during the last few years, did not exceed the limits set by the rise in productivity.

The very volume of investment still required to fight unemployment imposes moderation in wage claims, and it is more indispensable than ever today if we are to avoid restrictions to the current production drive.

Above all, this production drive would certainly be seriously obstructed if the well-known automatic mechanism which governs wage rates were allowed to turn accidental and transitory phenomena into determinants of durable cost increases.

The Money and Capital Market and Bank Liquidity.— There was a marked increase in the volume of new credit granted by commercial and savings banks and related banking associations in comparison with the preceding year; over the calendar year 1959 the increment came close to 800 billion lire, and, according to provisional figures, exceeded 900 billion lire for the year from May 1959 to April 1960. This is approximately three times as much as the corresponding increase in 1958 (308 billion lire).

The greater finance granted by the banks to an expanding economy took the form not only of direct lending but also of an increased supply of funds, mostly through the subscription of bonds, to the special credit institutions (for industrial, land ond agricultural credit); this amounted in 1959 to 167 billion lire, as against 85 billion in 1958.

The loans granted by these institutions in turn exceeded the 1958 figures; their lending operations, net of repayments and excluding finance for government stockpiling, raised the amount of outstanding loans by 302 billion lire in 1958 and by 427 billion in 1959—an increase of 125 billion on the rise of the preceding year.

By contrast, the funds raised by companies through share issues or the call-up of unpaid capital stock, and, in the case both of private companies and of the IRI and ENI, through bond issues, were less than those raised in 1958 (338 billion against 446).

The main explanation of this development is that in 1958 companies made exceptionally heavy claims on the capital market, which, it will be recalled, was very liquid and where, consequently, interest rates were low. Another contributory factor was that companies made few bond issues pending the expected reduction of taxes applying to this type of security.

Given the favourable conditions on the money and capital markets, post-office savings deposits rose by 175 billion lire in 1959, as against 131 billion in 1958, and it was possible to float a 300 billion lire issue of seven-year Treasury bonds last July, in connection with the finance bill for the supplementary investment programme.

Just as share and debenture issues were able to enjoy favourable terms, so the Treasury bonds could, for the first time since the last war, be placed at par and were taken up unusually quickly by numerous subscribers.

The Treasury again appealed to the market last January, and again with excellent results.

Another move by the Treasury deserves some comment. A bill tabled in Parliament last February provides that over the course of four years special ten-year Treasury certificates in the total amount of 429 billion lire are gradually to be placed on the market and to be redeemed within ten years. Nearly all of this is to be earmarked for the coverage and payment of losses incurred in the administration of stockpiles, mainly of wheat. There was never any budgetary provision for these losses, which kept on growing as a result not only of the cost of preserving the stocks but also of the interest charges on loans outstanding at annual closing dates.

The expansion of public expenditure provided for in the 1960/61 budget and in part due to the higher investment to which the government stands committed is not entirely covered by higher tax revenue. Accordingly, the budget estimates include a higher deficit than that initially envisaged for 1959/60.

For this reason, the Finance Bill again authorised the Minister for the Treasury to issue, in the course of the financial year, nine-year Treasury bonds up to the amount that may be necessary to cover the deficit, and also to refund 147 billion lire's worth of similar Treasury bonds maturing on 1st January 1961.

Thus we shall follow in the new financial year the same policy which we are fully implementing in the present one, covering the entire deficit by other than short-term borrowing on the capital market.

The banks' new lending operations, which our analysis has shown to have been brisk, the Treasury's 300 billion lire loan on the market, as well as the rise in the banks' compulsory reserves in due percentage of the increased deposits, all came to pass in 1959 without any, even relative, fall in the liquidity reserves in existence at the end of 1958.

The injection of new liquidity had its source mainly in the Banca d'Italia's credit balance on foreign exchange account; this rose from 1,351 to 1,920 billion lire and thus made a net contribution of 569 billion during the year. To this sum must be added the Banca d'Italia's new assets, consisting above all in rediscounted stockpile bills, in the amount of 55 billion lire. This makes a total of 624 billion.

Contrary to what happened in 1958, however, the Treasury created none but transitory liquidities on the market in 1959. The cash deficit in respect of budgetary and Treasury operations amounted to 304 billion lire (see table 17) and was almost entirely covered by public debt operations, including especially the 300 billion lire loan.

Part of the new liquidity, in the form of an increase of 176 billion in the money supply, was used to meet the greater demand for notes on the part of the consumers' sector of the economy, whose income and wage bill had risen; a further 270 billion flowed back through the mechanism of compulsory bank reserves. The rest indirectly influenced the volume of the banking system's primary reserves, which, as I said, rose in the course of the year by 176 billion in absolute terms, though their ratio to deposits remained almost unchanged.

It will be recalled that at last year's General Meeting I declared it as our purpose not to reduce bank liquidity, so as to maintain a quick and lively stimulus to back the expansion of production; this purpose has been achieved, though again, this year, in the presence of strong liquidity-raising factors. The measures we adopted were of a quantitative nature, so that we were able to avoid a change in the discount rate.

Thus a loan was floated which, given the relations between the Treasury and the Central Bank in Italy, is in certain respects comparable with open-market operations. We also left full play to the mechanism of compulsory bank reserves.

In avoiding a rise in Bank rate, our tactics were in line with the spirit of the policy which, as I said earlier, tends to dissociate measures aiming at domestic monetary equilibrium from those which, with sometimes contrary effects, influence international capital movements.

The liquidity-control mechanism was thus operated during 1959 with full regard to the need to encourage the most abundant possible flow of funds into the productive process and at the same time to maintain a favourable level of interest rates; through the above-mentioned measures to keep the discount rate stable and to reduce the banking system's short-term foreign indebtedness, we intended to make our own contribution towards an alleviation of the problem of international liquidity.

All this we were able to do essentially because, notwithstanding the lively expansion of demand, the price system displayed no appreciable strain.

For the same reason our policy underwent no major changes even during the first months of this year. As a matter of fact, the banks' primary liquidity reserves at the end of March were only slightly lower than at the end of December 1959.

If, as seems likely, foreign exchange transactions make no large claim on the Banca d'Italia this year, and if the budget deficit is covered by Treasury bonds, little or no new liquidity will be created.

None the less, bank credit conditions will continue to be easy; the banking system's present liquidity must be regarded as amply sufficient to offer a continuous inducement to banks to increase their lending.

In relation to the lesser liquidity, new bank deposits will most likely not have to reach or exceed the 1959 level. In 1959 new deposits amounted to 1,270 billion lire, as against 1,056 billion in 1958 and only 607 billion in the year ending in September 1957, which was still a year of expanding production prior to the slackening of activity which was a feature of 1958.

The loan/deposit ratio will thus have a tendency to grow, as indeed it has been growing, very gradually, since mid-1959.

The New Par Value of the Lira.— In the closing days of 1958 Italy, together with the major countries of Europe, adopted such legislative and administrative provisions as were necessary to introduce currency convertibility for non-residents.

More than a year's experience with the new system has amply proved that our currency's rate of exchange, which was at first adopted as a *de facto* rate and which later, with convertibility, became binding for the purpose of our international commitments within OEEC, could be established also within the wider framework of our relations with the International Monetary Fund, as well as for the settlement of accounts between the Treasury and the Banca d'Italia.

The advances registered by our exports since the advent of convertibility and the elimination of nearly all bilateral payments agreements testified, and continue to testify, to the correctness of our exchange rate.

This is confirmed also by post-convertibility developments in the field of capital movements. It must be admitted that, for the reasons I mentioned last year, capital exports from our country are still subject to severe limitations; but the large volume of foreign capital invested in Italian shares after the return to convertibility is in itself the clearest possible proof of what I said about the rate of exchange of our currency. It was, in fact, not a question of occasional purchases or purchases motivated by particular industrial purposes, but to a large extent portfolio buying, especially by institutional investors who were obviously not afraid of having to repurchase exchange at a premium in case they wished to repatriate their capital.

We may say that transactions in the wider and freer market created by convertibility in their turn bore witness to the correctness of our exchange rate. This experience confirms all the others of recent years with respect to our currency's ability to remain sound in changing cyclical conditions, such as we passed through ever since we put a stop to the inflation which had afflicted us during the war and again in 1946/47, after an apparent lull.

For these reasons our government was able to fix the new par value of the lira in perfect accord with the quotation established for some time on the foreign exchange market.

On 28th January 1960, the Banca d'Italia was authorised to revalue its own gold reserves at the rate of 703.297,396 lire per gramme of fine gold, which corresponds to a dollar parity of 625 lire.

The net proceeds of the revaluation, in the amount of 62.8 billion lire, were credited to the Treasury, but, to avoid the creation of new paper money, the very correct procedure was adopted of using this sum to cover Treasury debts to the Bank.

The new par value was proposed to the International Monetary Fund in accordance with the statutes, and the Fund concurred on 31st March 1960.

Some brief comments on the new par value of the lira may be in order in this house, where the duty to protect our currency from the injuries it may suffer any day takes precedence over any other duty, howsoever important.

Some fourteen years ago the great inflationary wave of the post-war years began to swell and to hit our country. We successfully introduced measures to stop it in August/September 1947, and these were supplemented during subsequent months by the introduction of rules, also of a constitutional order, to prevent inflationary financing of government expenditure.

What counted even more than the direct effects of these restrictions on the volume of bank credit (which, after a short pause, resumed its upward trend) were the indirect effects on the expectations of business men and on the balance of payments. The speculative hoarding of goods and foreign exchange was replaced by efforts to build up lire cash reserves. Together with a wise foreign exchange policy, this shift reduced import demand, liberated resources for export, and normalised the inflow of foreign exchange.

The overall result of the effects of these various real and monetary factors was the progress of our balance of payments towards a surplus which, while fairly large even in 1948, became conspicuous in the following year. It will be recalled that in the report for the year 1949 I was able to state that our foreign exchange reserves, which had been extremely low in September 1947, had by 1949 risen to approximately 900 million dollars.

The changing fortunes of our balance of payments during the first year of the war in Korea, and again during the post-Korea phase of expanding public expenditure and capital goods imports, during 1952 and the early part of 1953, demonstrated how usefull it had been to build up our reserves. They provided the buffer which made it possible for our country to proceed steadily with the development policy it adopted later and with the progressive liberalisation of foreign trade.

Our orderly procedure in pursuing the various objectives of a policy of stability and growth; the absence, since 1947, of the burden of excess liquidity or of massive monetisable public debt; the progressive reduction, especially since 1952/53, of the budget deficit, in absolute terms and, even more so, in relation to national income—these, in my opinion, are the general factors which enabled us to obtain effective results with a monetary policy which, simple in its means and sparing of intervention, was designed to confer autonomy and certainty upon the economic process. It was a stable and well-defined situation very different from that of other countries, where, partly because of persistent problems of excess liquidity and of public debt management, and partly because of lack of foreign exchange reserves, trade liberalisation proceeded jerkil and with setbacks, where business men were, and still are, alternatively prodded and hampered in the execution of their plans, and where private persons are now pushed forward and now held back, or pulled this way or that in their consumption and saving decisions.

The system of checks introduced in Italy in 1947 and 1948 is, however, not equally effective against all types of inflation. As I have repeatedly warned, monetary policy can adequately discharge its task of preventing the emergence of demand inflation, but it cannot, without grave hardships, stop cost inflation. Cost inflation can be avoided only if monetary policy, is accompanied by an appropriate wage policy, as I have already had occasion to remark today.

Taking an overall view of the present period of monetary stability, and assessing the situation in Italy in comparison with other countries, not excluding the United States, it must be admitted that the problem of cost inflation presented itself in our country in less acute terms. In most branches of manufacturing industry productivity rises made room for quite appreciable wage increases as well as for returns on additional capital investment. The most obvious case in point is perhaps the steel industry, where the productivity of labour doubled in less than ten years, so that, despite the enormous capital outlays, steel prices remained almost stable at 1950 levels. Unlike Italy, other major steel-producing countries experienced steel price increases which range from 40 per cent in the United Kingdom to 70 per cent in the United States and 90 per cent in Germany.

Finally, we must once more keep in mind that in an open economy, such as ours, there are always external influences at work. In a climate of mild inflation, such as persisted throughout almost the whole of the past decade in the western world, no country which is firmly integrated into a system of international exchange of goods and services (and Italy is one of these countries) could escape the international propagation of the slow upward movement of prices—especially with a system of fixed exchange rates.

Our own slight inflation, which is more noticeable in consumer than in wholesale prices, was to a considerable extent due to an upward adjustment of controlled prices, and for the rest was " imported ".

Still in comparison with other countries, we can say that not only trade union policy with respect to wage negotiations but also the pricing policy of firms was inspired by a sense of moderation. From this point of view, too, the liberalisation of foreign trade played an important part, and so did probably, at least in some cases, the co-existence in our economy of the two organisational forms of private and government-controlled enterprise.

I should like to point out, finally, that the establishment of the new par value of the lira coincides with a moment when the defences we have built up allow us to face with firm purpose and with confidence a phase of vigorous expansion of production and of domestic and foreign trade, such as we need to prepare the solution of our country's fundamental problems.

From this point of view the present establishment of a new par value for the lira differs radically from the two preceding ones in 1936 and 1927.

In comparison with twenty-five years ago, the capacity of the banking system, measured by the volume of deposits, has about tripled, and its flexibility has been proved, among other things, by the events of the past few years, as recalled before this General Meeting.

But side by side with the ordinary credit system, and independent of it, an efficient organisation for medium and long-term credit has grown up, which draws directly on the market for the bulk of its operational funds. Its importance will easily be appreciated if we remember that credits of this kind now amount to one-third of all bank credits.

The capital market, in its turn, has widened to an extent as yet unattained by countries richer than ours; investors other than banks last year purchased new stocks and bonds and government securities for about 1 billion dollars.

Finally, the position of the Central Bank has again become fully elastic. While twenty-five years ago more than three-quarters of the bank notes in circulation were backed by frozen credits, so that we had a recurrence of the difficult situation following upon the building and bank crisis in the 1890s, today a similar proportion of the bank note circulation is backed by gold and convertible currencies, so that movements in the reserves are, as they should be, immediately reflected in the monetary instruments which the Central Bank manipulates.

The establishment of the new par value of the lira thus really and truly marks the close of an era whose characteristics were profoundly different from those of the era which is now opening, and which, as I fervently hope, will bring us in the not too distant future a solution of our country's fundamental problems.