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Excerpts from the Governor's Concluding Remarks

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IX. *Excerpts from the Governor's Concluding Remarks*

Gentlemen,

This is the fifth time that I am called by my office to report to you on our country's monetary situation. Every year, I have had to give you a picture of quite different economic developments, and over the whole of the five years the chain of events moved from a situation of high promise—with expanding production, stable prices and an external surplus—first to a balance-of-payments crisis and then to stagnation at home. Now I can report on signs of recovery which justify the hope that we may in the near future assemble once more the positive elements of the initial situation and move along the path of growth again, less fast perhaps, but in a more orderly manner.

To do this, we must put to good use the lessons we have learnt, and suffered, in the vicissitudes of recent years. This is why I, who has had to live through them in a position of heavy responsibility, would like to take this opportunity to go beyond the events of the last year alone and to discuss the whole nexus of cause and effect, of action and reaction, which generated the ebb and tide of economic events during the whole five-year cycle.

The means by which public opinion is informed have become more numerous and better. But it is also true that the public at large has become much more interested in economic problems, just because recent changes in business conditions have been so dramatic, because they have so patently affected the situation of individuals and the economic branches in which they work, because government has intervened on such a large scale and because the outlook for the future has been so uncertain. Production, investment, consumption, costs, prices, profits, balance of payments and the relationships between all these magnitudes have ceased to be esoteric logical categories intelligible only to a small circle of experts, and have become the subjects of discussion in which political parties, trade unions and Parliament join with increasing frequency. This is a sign that we are progressing towards a more truly democratic order in which the members of the national community take conscious responsibility for the affairs of their country.

The complex events of the last few years, our successes and our failures, gain added interest, from the point of view both of economic policy and of economic analysis, by the great variety of new and unexpected factors. It has become clear, first of all, to what a large extent the development of a modern economy is governed by forces which cannot easily be controlled by the monetary authorities. Later, in the phase of adjustment, the Italian economy was seen to have retained its full capacity to transfer resources from domestic to external uses through equilibrating processes of a monetary nature which neither interrupted, let alone reversed, our country's progress toward integration with the world market.

While I shall limit my remarks to the sphere of competence of a central bank, I yet hope to make a contribution to the knowledge and understanding of all these matters by discussing in depth those aspects of monetary policy which are our more immediate responsibility. If I give no more than brief mention to strictly cyclical aspects having to do with production, prices and the balance of payments, it is in part because, as I have said, these are discussed frequently and widely, if only because people are anxious to discover in them at once any hopeful signs that may appear. In any event, these are thoroughly examined in the separate chapters of this Report.

The International Monetary System and Italy's Return to External Balance.— Before turning to the problems of the Italian economy itself, however, I feel I should first call your attention to a set of wider problems which have been the subject of so many new proposals and such lively debate recently, even if I cannot in my brief remarks do adequate justice to the complexity of the argument. I have in mind the problems of the present and future of the international monetary system.

Such as it is today, this system makes it possible to raise with lightning speed the financial resources needed to break any speculative attack launched upon the currency of a country while it takes steps to re-equilibrate its balance of payments. This has been demonstrated quite recently when sterling came under heavy pressure and the United Kingdom received financial assistance on an unprecedented scale, first through central bank support and subsequently through drawing on the ordinary resources of the International Monetary Fund as well as on special resources which the latter raised under the General Arrangements to Borrow.

But to acknowledge these merits of the system does not absolve us from the obligation to look also for any demerits it may have and for ways of eliminating them.

The most serious drawback of the current international monetary system is commonly stated to be that the chief source of international liquidity creation is the deficit in the United States balance of payments. Since 1958, the United States incurred a total deficit of 21 billion dollars, and only 7 billion of it were covered by gold sales from the U.S. Treasury to the central banks of surplus countries, especially in continental Europe. The remaining 14 billion dollars largely accumulated in commercial and central banks elsewhere than in the United States, and more than one third of them, again, in continental Europe. To the extent that they are in central banks, they are used as currency reserves.

The critics of the present system say that in the absence of these dollar balances the government of the United States would have been forced to re-establish external equilibrium quickly. They also say that the very size of the U.S. deficit and the fact that it was partly financed by European central banks purchasing dollars against national currencies were one of the causes, and perhaps the chief cause, of the inflationary pressures in Europe. The argument is that prices are pushed up by the excessive purchasing power injected into the market by the dollar purchases of the central banks, and that higher prices in turn push up wages. It is also argued that simply to aim at aligning wage increases with productivity increases without doing anything about this excess flow of monetary means to the market would mean wanting to remove the effects without eliminating the cause.

The conclusion of all this is that the only dam which can hold back the flood of purchasing power which originates in the United States and threatens to submerge Europe is a return to the gold standard.

There was a time when ideas of this kind had a consistent counterpart in the view that the mechanism of competition could, and should be left to, re-establish external balance through appropriate wage adjustments.

In the more recent pronouncements on the gold standard this link with other, parallel, processes of spontaneous adjustment has been passed over in silence. Most likely, it was not thought possible to resuscitate a model of the labour market which has been overtaken by modern conditions. Today, the institutional presence of trade unions has become so decisive that it has been said of them that their conduct is ultimately the arbiter of monetary stability. But we may well ask whether the gold standard, so stripped of the other elements which formed part of the system, can be revived at all, and if so, whether it should be revived if it means not indeed a return to competitive labour markets but adaptation at the cost of intolerable levels of unemployment.

Because such repercussions are possible, I have my doubts about the wisdom of an outright return to the gold standard. I would add that while I regard the joint responsibility for monetary stability which theory attributes to the trade unions as a matter of highly desirable progress and maturity, I do not believe that the monetary authorities may neglect to put such means as they possess to resolute use whenever circumstances require, so as to safeguard confidence in the currency.

Others propose that we should abandon the fixed exchange rates which underlie our present international monetary system and should adopt instead a system of flexible exchange rates. This proposal is placed in a different context, but still has a certain kinship with the model of freely operating market forces. But it must be remembered that flexible exchange rates are only apparently an expression of market forces. In practice, government and monetary authorities can and do influence both the spot and the forward rate and they can and do control short-term capital movements, so that flexible exchange rates would be a solution strongly subject to economic policy purposes which may conflict with the orderly expansion of world trade and imply the risk that one country may shift its own difficulties onto other countries. What would happen in fact is that we would do away with something which today is a firm point in our economic system and replace it with a mobile barrier which could hardly be protected from the pressure of particular interests.

In actual fact, the gold standard as such, that is, to the extent that it worked according to its own logic and was not arbitrarily amended by correctives superimposed upon its purely automatic mechanism, presupposed an economic setting in which the size of the public sector, the degree of sectional organization of economic forces and technological rigidities were very different indeed from those we know today. Just to stress a few rules of monetary conduct without reference to the underlying structural conditions which also were an integral part of the system, contributes nothing to an understanding of the problems either of the past or of the present. As has been made abundantly clear by many and well-documented studies, much was done even in the past by the deliberate intervention of monetary authorities, by the use of various techniques of intervention and by ad-hoc forms of reciprocal assistance, to reconcile the internal requirements of monetary policy more flexibly with those deriving from the intrinsically international nature of the gold standard.

However, a critical re-appraisal of the past in no way invalidates the principle that no country can go on for long either accumulating or losing reserves and that situations of this kind demand appropriate corrective policies. But to recognize this fundamental need does not mean, or imply, that whatever adaptations are necessary should no longer be made with deliberate judgement, at a measured pace and with the help of institutional collaboration. All this has become part and parcel of our international monetary system today, and there can be no question of renouncing it. The same reasons lead me to say once more, as I have often done before, that I take a very favourable view of the various forms which monetary co-operation between governments and central banks has taken in the last few years and also quite recently. This co-operation constitutes not a haphazard and occasional sort of support which would almost be a symptom of the present system's weakness, but on the contrary links the working of the system to responsible human decisions and so testifies to its flexibility and development potential.

Whatever form this co-operation has taken on the multilateral and on the bilateral plane, Italy has always gone along with it in the firm conviction that this road was patently preferable to any alternative open to us at the moment, such as devaluation by countries whose currencies are under pressure or else the adoption of flexible exchange rates. The effects of these alternatives can, of course, be assessed only by conjecture and hypothesis, and therefore they leave a wide margin of uncertainty as to what repercussions and, most likely, chain of emulation would actually follow. Reciprocal aid, on the other hand, is at one and the same time the fruit of operational practices which have stood the test of experience and a means of evaluating the procedures adopted and improving them in the light of experience.

It is indeed precisely thanks to this practical and empirical approach that as a matter of monetary techniques a credit component has definitely come to stay as part of external liquidity in our international monetary system, in whatever way we may amend it. But claims rest on trust, and because of that require that the authorities which hold reserves should be free to choose by what reserve assets they wish to supplement gold. I say this with respect to the currencies which exercised reserve functions in the past and still do: the dollar, sterling and French franc. These currencies have become widely acceptable through a process of free conditioning and in substance because they are directly or indirectly convertible into gold and, ultimately, into goods and services. If, on the other hand, new reserve assets are created on the basis of world trade needs by formal decision either within the International Monetary Fund, or more suitably, within the Group of Ten in association with the Fund, then the acceptability of these reserve assets would have to be governed by agreements which lay down the obligations of creditors and debtors alike.

For these reasons, I believe that the timely studies which were made last year on the functioning of the international monetary system and its probable future needs of liquidity should be carried forward in the same spirit of constructive collaboration which suggested this method in the first place. The purpose should be not to remove the problems under investigation from public discussion, but to look for the basis of possible solutions without indulging in utopian expectations or oversimplifying predilections which seem hardly compatible with the complex working of modern economies.

Italy's support of this approach has, among other things, found expression in the choice of one of our countrymen to become chairman of the Study Group which has been asked to evaluate the various proposals for the creation of new reserve assets to supplement gold, as and when assessed long-term needs so require.

Another proposal which has come up in the course of reappraising the working of the international monetary system is that there should be multilateral surveillance of the ways and means of financing balance-of-payments disequilibria.

I believe that procedures of this kind may prove useful in adapting the volume and forms of finance to the nature of the imbalance; once we have more knowledge of these questions, as we should soon have thanks to the studies in hand, they are also likely to lead to the speedy adoption of such corrective measures as may be found expedient in any particular case.

There are, definitely, ways in which our present international monetary system can evolve, and, as I have said, they imply the continued use of fiduciary assets to supplement gold in reserves. However, the extent of this fiduciary component should not be tied to the balance-of-payments vicissitudes of particular countries, but should be ruled by world trade needs and its creation subject to multilateral surveillance. Within the same framework, we might also work towards agreements on the proportions to be observed in the qualitative composition of reserves as between traditional assets and such new ones as may come to join them.

A common policy of exchange reserve administration could combine different objectives, as follows:

(a) An undertaking by central banks to finance balance-of-payments surpluses and deficits subject to an agreed proportion of gold and dollars or other reserve currencies would remove the process of creating fiduciary international liquidity assets from the discretion of countries which issue reserve currencies.

(b) At the same time, changes in the proportion of gold and other reserve assets would enable the volume of the credit element to be adapted from time to time to international liquidity needs, without tying its creation to the supply of newly mined gold.

From the point of view of their effects on the volume of international liquidity, these solutions are equivalent to a change in the price of gold; but unlike the latter, which would have patently undesirable consequences, they would make room for flexible adjustments in the light of changing conditions on the world market. I would say that these solutions appear to me as an indispensable condition of any progress toward closer monetary integration among the industrial countries and also of any possible reform of the international monetary system. No reform should overlook the need for a mechanism which can, if it proves necessary, provide the world economy with additional owned reserves and possibly with automatic credits. Nor should reform try to do away with reserve currencies, but should instead take care to safeguard equal treatment for all the currencies of major industrial countries. No reform, finally, should refuse to acknowledge that the sterling balances of the United Kingdom are, at least to some extent, a common problem of us all. If these conditions are fulfilled, the controversy regarding the nature of new reserve assets and the method of their creation and distribution should surely be amenable to reconciliation.

Lastly, wider recourse to the International Monetary Fund would have the distinct advantage of channelling to the Fund part of those central-bank debts and credits which are components of international liquidity. This would mean that credits to finance external imbalances would remain within the limits of each country's quota with the International Monetary Fund.

Turning now more particularly to the problems of the Italian economy, I shall focus my remarks on what I consider to be the two main responsibilities of monetary policy, namely, to maintain equilibrium in external payments, and to encourage the formation of saving and control the flow of credit towards investment.

In discharging our responsibility with respect to external equilibrium, we availed ourselves of the manoeuvering space which our currency reserves and international monetary collaboration allowed us, but we accepted the condition of a stable rate of exchange. This very condition implies for our second main responsibility that we must determine the volume and guide the flow of credit in such a way as to maintain a certain degree of domestic price stability.

The transition of Italy's balance of payments from a period of deficit into one of surplus was due in large extent to the combined effect of the economic system's own forces and our policy of containing credit expansion. The Italian economy was protected by deep ranks of firms which had previously raised their efficiency by investment, and this is why foreign demand could expand at a time of falling domestic demand. We only need to look at the output and export figures of the various branches of industry, and at those of domestic supply and imports to see what conspicuous proportions the substitution of foreign for domestic demand and of domestic for foreign supply assumed in the most dynamic sectors of our economy —and these are the self-same sectors which enlarged and modernized their productive capacity thanks to the credit expansion of 1962 and 1963.

But the monetary authorities eventually had to take steps to hold back credit expansion gradually, if only to prevent an excess of domestic money supply from propagating inflationary effects abroad through persistent deficits in the balance of payments. It is not proper for a responsible member of the international community to go on accumulating deficits of the order of magnitude as occurred between the fourth quarter of 1962 and the first quarter of 1964; even when their effects are mitigated, as they were in our case, by international credits, they demand forceful countermeasures. During that period, we incurred a total deficit of 1,855 million dollars, and we financed it by mobilizing one after the other our sources of external liquidity. The lion's share of 955 million dollars was drawn from the short-term credits which Italian banks obtained from foreign banks; we liquidated 115 million dollars' worth of short- and medium-term assets; we incurred 110 million dollars of short-term liabilities; we used up 375 million dollars of convertible currencies and drew another 202 million of them from the International Monetary Fund; only the small residual amount was covered by gold sales.

This is how we surrounded our gold reserves by a protective layer which absorbed the great bulk of the deficit. The effects are now manifest in the net foreign debts of our banking system. In due time we shall redeem these debts, but it is not least for this reason that I believe that policy decisions regarding the use of reserves should be based on the proportion of gold not in gross, but in net reserves.

I have heard it said that the measures taken in Italy to get external payments back into balance were too harsh, that the crisis was not as severe as the monetary authorities thought and could have been met with milder action. But a deficit of 1,855 million dollars in 18 months is certainly not small by international standards. The persistence of deficits of similar magnitude in the balance of payments of the United States has indeed caused some voices to be raised in favour of measures resting on the principle that no nation should be allowed to export its own inflation through its balance-of-payments deficit, and that any deficit country should settle in gold and only in gold, restricting its money supply to match the loss of gold reserves. It makes one shudder to think what the consequences would have been in Italy, where the economy experienced a credit tightness judged to be excessively severe, even though the monetary authorities made good, and more than good, the whole of the liquidity drain of the external deficit. The plain figures bear witness to the gravity of the crisis which our country suffered and by that very fact show up the extent of the effort by which our economy overcame this crisis. Notwithstanding the sacrifice it involved for our level of investment, we can appreciate the full measure of this effort by recalling that virtually all the additional real resources produced in the country in 1964 were used to improve the balance of our exchange of goods and services with abroad.

During the twelve months ending in March of this year we had a surplus of 1,282 million dollars in our balance of payments. Of this amount, 297 million went to reducing the banks' net indebtedness abroad. We added 736 million dollars to our gold and convertible currency reserves and built up a credit position of 173 million with the International Monetary Fund; the rest was used up in minor assets.

Last April we transferred to the accounts of the Italian Exchange Office gold assets previously credited to banks and bought some gold from the U.S. Treasury. In this way we raised our gold holdings back to what they were on 28 February 1964, just ahead of that fateful month in which the balance-of payments crisis exploded in our faces. The wounds which external deficits succeeding each other throughout 18 months inflicted upon our gold reserves have healed.

I would not wish to state this fact without adding once more a tribute to the monetary authorities in other countries, for their prompt and generous help in the hour of our greatest need. I also want to say how much we appreciate the proofs of confidence shown to us by the long-term lenders among the international agencies, such as the International Bank for Reconstruction and Development, which recently extended another 100 million dollar loan to the Cassa per il Mezzogiorno, or the European Investment Bank, which by now has a total 341 million dollars outstanding in loans to Italy.

The Control of Bank Liquidity. The Use of Credit by Firms in the Public and the Private Sector.— As regards the problems of monetary control I want to take issue first with the widespread view that a period of expanding production was followed by a period of contraction because of credit restrictions introduced by the decision of the monetary authorities. We are here in the realm of statistically verifiable facts, and can reply by quoting figures about the events under discussion.

Our budgetary and monetary policy were repeatedly criticized in international circles as being altogether too rash. Not longer ago than May 1964 some of this international advice was still that we should not only contain the growth of public expenditure within the limits of foreseeable real income growth, but also space out our investment expenditure more gradually over time, stiffen our income tax and perhaps even raise at once our turnover tax rate. The idea was that an increase in revenue of some 400-500 billion lire during the financial year should be used to reduce the budget deficit, and that we should re-inforce the policy of credit containment, which we initiated in the course of 1963, by imposing a strict ceiling on credit expansion.

The Italian government was not in full agreement with this diagnosis nor, therefore, with the therapy proposed. The government did not then, nor did it on earlier occasions, introduce measures to restrict total demand, with the exception of some hire-purchase sales. What the government did instead was to take steps intended to re-shape the structure of demand, by channelling the purchasing power withdrawn from consumption towards the financing of public and private investment.

Public spending, understood as the sum of expenditure by government, autonomous government agencies and local authorities, did not at any moment exercise deflationary effects, as some say; and this is true whether we look at public expenditure from the point of view of its volume, the way in which it was financed or its purposes. On the contrary, the effect was inflationary: public expenditure has been growing uninterruptedly, mainly under the impact of direct or indirect rises in personnel costs, which meant that no major new flows of real resources were generated. This was another reason for the inflationary effects, for to the extent that growing expenditure was covered by taxation, it helped to push up costs, and to the extent that it was financed by borrowing, it raised the supply of money, quasi-money and securities. The new debts contracted in 1964 by government, autonomous government agencies and local authorities between them absorbed one third of all the savings which the nation, including the Social Insurance Funds, set aside during the same year in cash, deposited with the credit system or invested in securities.

When I spoke to you three years ago at our General Meeting of Shareholders, I drew your attention to the circumstance that in our economy labour costs were racing ahead of productivity, and I pointed out that to the extent that higher labour costs were not transferred onto prices, firms saw their self-financing capacity impaired and ultimately had to rely more heavily on outside sources of finance. While all this was happening, I added, the public sector's investment programmes in excess of its possible saving were tending to expand, so that public investment also was becoming more dependent upon borrowing. These public claims, too, largely concentrate on the special credit institutes, which in their turn raise the bulk of their loanable funds by bond issues.

In view of this situation and of the foreseeable need for funds in connection with the transfer of electricity companies to E.N.E.L., the new National Electricity Board, I announced that we would take steps to widen the capital market; the central bank, I said, would help to give the economy a system in which funds can easily be transferred from one category of uses to another and channelled towards those which are held to be most in the public interest. The intention was to improve the links which connect the money market with the capital market and make the interest rates in both more closely interdependent. But I also warned that the flow of finance would still have to be conditioned by the real factors underlying the ultimate sources of the supply of saving.

Credits advanced on the short, medium and long term to the private and public sectors of the economy, excluding the Treasury, increased uninterruptedly throughout the years 1961 to 1963. The figures are 3,334, 4,325 and 4,527 billion lire. Last year long-term credits to the economy still expanded, but short-term credits to it dropped sharply in spite of greater bank liquidity.

Now, the size of the capital market is measured by the sum of long-term funds, including the proceeds of equity issues by companies, which reach the economy in any given period. The figures show strong expansion between 1961 and 1962, then slight contraction in 1963, followed by renewed growth to a record 2,844 billion lire in 1964.

The capital market was widened by transferring monetary assets to it through two main channels, as follows:

(a) Bond purchases by the Bank of Italy and other institutions which obtain from it the liquid funds which they invest; bond purchases by banks, financed by their own means and by the sale of Treasury Bills to the Bank of Italy on the occasion of the change in the composition of compulsory bank reserves. All told, the credit system took up bonds in the value of 663 billion lire in 1963 and of 845 billion in 1964.

(b) Net loans by banks to their Special Sections handling long-term credit and to special credit institutes in which they own part of the equity; direct loans especially by savings banks and their banking association, and by the Central Post Office Savings Fund. The total funds involved in operations of this kind amounted to 575 billion lire in 1963 and to 767 billion in 1964.

Bank liquidity depends in some part upon interventions by the monetary authorities, which interventions in turn may have an immediate or a delayed effect; in some part it depends upon other, autonomous, factors. Accordingly, three liquidity effects have been quantified separately in this Report [Table 34], as deriving from autonomous factors or intervention by monetary authorities, and in the latter case, from their own operations or from operations they authorize.

Let us again look at the figures, taking the two nine-month periods from April to December 1962 and 1963, which are usually described as periods of abundant and tight credit, respectively. The increase in bank liquidity imputable to direct operations by the monetary authorities was 367 billion lire in the first case, and 737 billion in the second. In other words, direct operations by the monetary authorities created twice as much new liquid assets in the period of allegedly tight credit than they did in that of allegedly abundant credit. During the nine months of alleged credit shortage, the authorities thus more than made good the liquidity loss due to the balance-of-payment deficit, and in addition left the banks free to raise another 268 billion lire of liquid assets by borrowing more abroad.

There are yet other figures by which to prove my point. Let us look at the total money supply injected into the economy through credits and security purchases by the banking system as a whole, including the Central Post Office Savings Fund; we see that during the period when it was our policy to contain the credit expansion, more credit was actually created than during the corresponding period of the preceding year. The figure for April-December 1963 was 2,736 billion lire, as against 2,433 billion for April-December 1962. Credits to the Treasury net of the latter's credits to the Economy amounted to 154 and 190 billion lire, respectively, during the last three quarters of 1963 and 1962, and the combined figures for the two sectors were 2,890 billion lire in 1963 and 2,623 billion in 1962—always taking only the last nine months of the year [Table 35].

During the period April-December 1963 some 614 billion lire of the money assets which the banks lent to the Economy and the Treasury were spent on financing the external deficit, which was largely due to excess imports of goods and services. To this extent the funds did not return to the banking system, and consequently the credit expansion of 2,890 billion lire increased the public's liquid assets, including primary and secondary liquidities, by only 2,276 billion.

At the same time the index of industrial production showed that the process of expansion was coming to a halt. What happened was that even a credit expansion of such exceptional magnitude as occurred throughout the second half of 1963 was unable to offset the capital shortage from which firms suffered as a result of cost increases not passed on to prices. The consequent contraction of investment set in motion a process of recession; credit expansion did mitigate its severity, but went beyond the public's willingness to hold liquid assets.

Monetary policy during the period April to December 1964 was designed to let bank liquidity rise under the impact of an excess of foreign-exchange purchases over foreign-exchange sales in connection with the balance-of-payments surplus, and indeed to create yet additional liquidity by other operations. As a result, the banking system acquired twice as much liquid assets as it had done during the corresponding period of 1963, but this liquidity gain failed to have any multiplying effect on credit creation. During these nine months of 1964 credit, including security purchases, expanded by 1,626 billion lire and the public's gross liquid assets by 2,383 billion, the difference being equal to the surplus in the balance of payments.

Its larger supply of liquid funds induced the banking system to extend more credit especially for public works and land reclamation, and to firms in the mineral oils, chemical, metallurgical and engineering industries; but firms did not feel induced to use these credits in correspondingly higher measure. The economic system seemed to be stunned by the succession of events to which I drew your attention more particularly on the occasion of our Meeting on 31 May 1963; the prevailing climate of uncertainty was as yet hardly relieved by the recent introduction of counter-cyclical measures.

Now let us draw some conclusions:

(a) The statistics do not bear out the statement that a period of exceptional credit expansion was followed by one of exceptional contraction. Intervention by the monetary authorities occasioned more liquidity creation during the period of alleged credit shortage than during that of alleged abundance.

(b) Long-term credit flows to the economy expanded strongly in 1962, remained at high levels in 1963 and again expanded in 1964. Short-term credit expanded as much in the second half of 1963 as it had done in 1962, and when it stopped expanding in 1964, it was at a time of greatly increased bank liquidity.

(c) In the presence of yawning balance-of-payments deficits, credit supply was kept below demand for credit and thereby the formation of additional monetary assets was gradually brought closer to the public's willingness to hold them, and so we created the conditions which enabled the external deficit eventually to be eliminated.

Everything I have said so far, and the above conclusions, rest on an analysis of aggregate magnitudes. If we examine the underlying separate figures, we see disparities of sometimes major extent in the behaviour of big and small banks, big and small firms, and firms in the public and the private sector of the economy.

When the banks were suddenly faced with an increase both in the demand for new credit and in the utilization of existing credit lines, they reacted by keeping a closer watch on the amount of each advance. Some firm or other may have found itself able to borrow less as a result, though the sum of credits actually drawn increased as I have said.

The behaviour of the banking system has come in for some criticism. It has been said that the banks restricted credit just at the moment when firms badly needed more loans. But it must not be forgotten that when the credits were originally conceded, the requirements of each borrower had been assessed by the yardstick of normal conditions, conditions, that is, when credit requirements tend to vary within limits more or less predictable on the basis of experience, and moreover to vary in opposite directions as between different sectors and firms. But now firms were suddenly deprived of a large part of the funds with which they formerly used to finance production, and so they all rushed to the banks with insistent requests for new credits and wanting to draw more on their existing credit lines even than had originally been arranged. It was the banks which ultimately had to sustain the shock of the vast changes in income distribution which had come about in so short a time to the accompaniment of a sharp rise in prices, and this is why the flood of credit demand converging upon the banks had to be dammed in.

There is a lesson to be learnt from these events, and it is this. If the distribution of income among the factors of production had the benefit of the responsible collaboration of organized groups, we would be creating one of the conditions necessary not only for safeguarding the purchasing power of money, but also for a credit supply not subject to wild fluctuations.

This latter purpose will be well served by the activities of the Central Risk Pool and by careful interpretation of the information it furnishes. The limit above which individual credits have to be notified has now been lowered to 100 million lire and we expect to lower it again. I think I can say that we have set up a service organized on modern lines and employing the most advanced techniques.

The differences in bank reactions to large, medium-sized and small firms are at least in part attributable to the different degrees of credit utilization by these three categories. A survey of data come to hand at the Central Risk Pool between March 1964 and March 1965 showed that firms to which total credits between 250 million and 1 billion lire had been extended actually drew the largest proportion of these credits; above the 1-billion line, credit utilization was generally somewhat lower and, after September 1964, decreased more rapidly than the average, and this was especially marked in the highest size class of total credit extended. As regards smaller firms, which had borrowed a total of less than 250 million lire each, the latest investigations seem to suggest that these are in the habit, perhaps not least for prestige reasons, to take up more credit than they normally need; this gives them a more flexible and cheaper margin of cash than other firms dispose of.

If the credit distribution is such that firms in the medium range of total borrowing use the greatest proportion of the credits extended to them, these same firms naturally suffer most at a time when an effort is made to contain the credit expansion.

I have more than once had occasion to draw attention to the element of rigidity deriving from the circumstance that many large firms had in hand major investment programmes for plant extension and new construction, just when the cost/benefit ratio changed to their detriment and deprived them of some of the funds on which they had counted. Because the construction programmes which were already going forward could not be interrupted without destruction of wealth, the large firms needed more long-term and short-term credit, and as access to the capital market became harder, they had to rely more on short-term credit. Thus they drew heavily on such credit facilities as they had left unused so far, and more especially on overdrafts on current accounts; the medium-sized firms, on the other hand, which had already used up more of their credit facilities, soon came up against an absolute barrier.

The increased pressure of the large firms' demand for bank credit concentrated largely on the biggest banks, and it was the latter which had to rely most on recourse to the Bank of Italy and on borrowing abroad. Once current investment programmes were completed, the credit demand of the large firms, which had not in the meantime started new programmes of similar magnitude and also found the capital market more receptive, became less pressing, with a consequent easing of the strain for the banks upon which this demand had largely converged. But the first to respond to the signs of recovery in production were the medium-sized banks; their ready reduction of the interest charged on loans proved an incentive for the larger banks to do likewise.

We made all these adjustments in the money supply without altering Bank Rate, contrary to some of the advice proffered to us at international level. In last year's Annual Report we underlined the consequences of a system under which banks raise funds from the Bank of Italy, from other Italian banks and from foreign banks at different rates of interest. It may be worth probing a little more deeply into this matter and trying to identify the elements of rigidity and flexibility in our pattern of interest rates.

It is not news to anyone that we have often had occasion to point out that the system of interest rates the banks apply in their relations with clients is far from perfect and that something would have to be done about it one day. Under this system there is a lower limit for interest charged to clients, and a ceiling for interest paid on deposits. It follows that at a time when money is scarce and the rates charged to clients go up, the banks, if they stick to the rules, should raise the interest on deposits to its ceiling, but not beyond. Conversely, when loanable funds are in ample supply and the banks charge less for loans, they can never charge less than the lower limit. This lower limit is connected with the level of Bank Rate, and would go down if the latter were lowered. But the same result could be obtained without any change in Bank Rate, simply by altering the relationship between the rediscount rate and the interest rates applicable to the various lending operations.

During the 18 months when our balance of payments was in the red, the money supply generated by the budget deficit offset that absorbed by the external deficit; operations carried out, or permitted, by the monetary authorities created an additional 1,597 billion lire of liquid assets, of which 404 came from the Bank of Italy through rediscounts, 473 were borrowed from banks abroad, and the rest was mobilized mainly through security operations and changes in the rules concerning compulsory reserves. The rate of interest paid for foreign bank credits was higher than Bank Rate. Yet the very volume of these credits demonstrates that high interest rates are no deterrent to large-scale borrowing by the banks when they need funds.

The system of interest rates paid and charged by banks under the interbank agreement certainly does contain an element of artificiality, in that it prevents the rates from adapting themselves flexibly to the conditions of supply and demand with respect to money resources. This artificiality will have to be removed sooner or later. But, it should be added, if we want a more competitive banking system, we shall need gradually to reorganize it. In some cases this means merging separate banks, and this we are doing, with due caution and with the collaboration of the banking associations; however, this implies no departure from the objective of having our credit system based on a large number of mutually independent decision centres. Through its Inspection Service, which was very active last year, the Bank of Italy learns of unsound positions and in such cases promotes a concentration of banks which is better in line with the size of a market open to domestic and international competition.

The slowing-down of the Italian economy in 1963 and 1964 could hardly fail to freeze up some funds and occasion some losses. Neither phenomenon assumed the sort of proportions known from earlier recessions, but the banks did feel the shock, not least because of the very size of their commitments in firms, and especially those of more recent creation. The banking system as a whole stood up well enough, thanks to the safeguards by which the Bank Law of 1936 protects the public's savings. There were some victims, but they were usually small banks and more especially banks whose majority shareholders had channelled credit to other firms they owned and whose management, for one reason or another, proved ill chosen.

Wherever a critical position developed, we intervened in compliance with what we believe to be the fundamental principle of the 1936 Law, namely the protection of depositors. The willing collaboration of banks and banking associations greatly facilitated our task. In some cases we took steps to have shareholders replaced. I would note in passing that the absence of any rules which make the transfer of equity in corporate banks subject to control hinders us in our supervisory functions. We can strengthen the Service; we can multiply inspections. But we cannot close our eyes to the fact that, however many inspections we do carry out, we cannot safeguard depositors unless the bank managers to whose astute judgement the public entrusts its savings, conduct themselves, as in fact they do, with the strictest correctness.

The laws which govern savings banks and stress the public-interest aspect of savings deposits, and the Bank Law of 1936 which reaffirmed the same principle, were both intended to make sure that no person unfit for the heavy responsibility of looking after other people's wealth had access to the board of directors or the management of any bank. I think it is necessary to recall these principles of the law. I think also that it is my duty to point out what serious consequences would follow if the spirit of the law failed to be observed both by the public sector which is responsible for nominating the managing staff of savings banks, public-law credit institutes and the banks of national interest, and by all those with administrative responsibilities in people's co-operative banks, other credit co-operatives or private banking firms.

It is incumbent upon those who fashion credit policy to adjust it continually to the needs of a growing economy, and more especially to do everything they can to eliminate the obstacles which impede the entry of new firms and which are enhanced by the very discontinuities created by technological progress. In many sectors the optimum size a firm must have to be competitive tends to grow, so much so that in some cases it might become necessary to reorganize the whole set of firms belonging to any sector with a view to adapting company structure to the new technical conditions. A case in point is the cotton industry, which in other market economies has been reorganized systematically by measures jointly planned by the public authorities and the firms themselves. All this, for the rest, is by no means extraneous to the institutional set-up of the credit system, which also needs to modernize itself with a view to making a positive contribution to the maintenance of effective competition.

One of the causes of an investment distribution other than optimal from the point of view of the system as a whole is the influence which the financial power of firms has on investment decisions. In so far as they have new techniques or new products to introduce, the big concerns can more easily raise the funds they need. The danger is enhanced when these concerns can command preferential treatment because they belong to the public sector.

Large firms, especially in the public sector, have the advantage over small ones that they can borrow at the same time from several banks. The statistics confirm that the number of banks which lend to any one client is highest when the total credit is largest, and lowest when the total credit is smallest.

Credits of small and medium amount are those scrutinized most closely. Banks seem to think that such credits involve heavier risks because the firms to which they are extended might go bankrupt, whereas credits to large firms, especially those in the public sector, are thought to be immune from this particular risk.

In all cases when several banks extend credit to one and the same firm, the group of lenders includes big banks and small banks. The big banks are surrounded by a cluster of small ones, as if the formers' judgement in itself were a sufficient guarantee; it looks occasionally as if the smaller banks proportioned their lending to that of the big ones, simply applying a reduction factor.

So much about the rigidities which prevent the volume of credits adjusting itself to changing business conditions and which tend to throw the main burden of such adjustment onto the small and medium-sized firms of the private sector. The principal reasons for these rigidities are the large requirements of the public sector and especially local authorities, as well as those for major public works and large-scale industrial plant, constructed on behalf of firms in both the private and public sector, under programmes stretching over several years. Another source of rigidity is the pressure which such firms exercise on short-term credit whenever they finance their requirements (as in fact they do) by recourse to short-term or indeed to long-term credit just at a time when medium-sized firms should have more short-term credit.

In modern economies investment in public works and industrial plant under programmes spaced out over a number of years tends to absorb a growing share of total investment. But this requires a continuous flow of saving, because otherwise it might become necessary to finance the completion of the programmes by expanding liquidity. Financially advanced countries can count on a continuous flow of saving because of the sheer volume of insurance, life and pension funds. In our country the creation of an efficient capital market is impeded by the scarcity of pension schemes based on accumulated funds and by the proposal that they should be abandoned altogether.

The Economic Factors behind the Monetary Factors and their Interdependence.— Having assessed the measure of the monetary phenomena which accompanied our economy through its vicissitudes during the last few years, and the part attributable to public expenditure, external relations and the credit system, we should now try to analyse what was behind these monetary phenomena. To this end we need to look further into the past and recall certain features of the development process which followed postwar reconstruction from, say, 1950 onward. Starting from a position of pronounced and almost universal technical backwardness, the Italian economy has moved forward since that time to levels where some industries at least can stand comparison with those of the most advanced economies. Over the course of those years, new doses of factors of production called forth more than proportional increases in output. Assuming that these increases, to the extent that they were more than proportional to the additional capital and labour employed, were attributable to technical innovation, statistics show the latter to have been responsible for about half our income growth since 1950.

The largest doses of new capital and labour, and the lion's share of technical innovations, went into industry, and this is where, therefore, the development process concentrated. The supply and income of the industrial sector grew at a strikingly faster rate than aggregate supply and income, and demand for the products of other sectors outpaced their supply. Foreign demand was in continuous expansion and, by creating outlets abroad for Italy's excess supply of industrial goods, played an essential part in sustaining and guiding economic development. The growth of supply in industry was not adequately reflected in a fall of prices for industrial goods, and excess demand in other sectors pushed up the prices of other goods and of services.

As trade with the world at large intensified, domestic prices came more and more under the influence of international prices, and wages, too, rose towards the levels of the industrially most advanced countries. This upward movement gained added impetus from the growing pull exercised upon our labour force by countries which use Italian workers on a large scale and found the inflow of labour from elsewhere interrupted in the middle of a boom.

The tendency of Italian wages to approach levels prevalent in countries with much higher average incomes per person employed aggravated the strains to which the system of production was already subject. If industrial wages were tending towards equality with those paid elsewhere in the European Economic Community, this was bound to widen the gap between labour incomes in different sectors at home. The very widening of the range of wages generated pressure to narrow it down again by raising the lowest wages. Under the cumulative effect of the original impulse and the successive sectoral adjustments, average wages in the system as a whole rose more than productivity; at the same time the growing concentration of labour forces in the large urban conglomerates, which offered better chances of economic advancement, created a climate in which wage claims were pressed home more and more vigorously.

If we look at our situation in comparison with that of the industrial countries with which our relations are closest, we see that for a long time our economy's rate of growth matched or exceeded theirs, then fell behind theirs during the two years 1962 and 1963, until, most recently, economic growth in these countries still continued but ours lost its impetus and almost came to a halt.

Let us look more closely at the period when production developed fastest. In this period, we can identify the following features. Average cost tended to fall, and this was reflected in an increase in exports thanks to more competitive prices; expanding exports drew factors of production into the most competitive sectors; the fall in average cost, which was only partly passed on to prices, raised profits and hence investment in plant, and this in turn further raised the productivity of labour; the more productivity rose, the more our goods became competitive and encountered growing demand; in this way job opportunities went on increasing to the point when labour, and especially skilled labour, began to be scarce. But we note also a signal failure to use income for social investment to create the sort of environment without which the orderly progress of a society based on the respect of human liberty would be very difficult indeed.

In these conditions wages began to rise, and with them average costs. To the extent that these increases were passed on to prices, they lowered our competitive strength and curtailed foreign demand; to the extent that they were not passed on to prices, they cut into profit margins. The result was a smaller propensity to invest, and hence a smaller demand for capital goods and ultimately a smaller total demand.

It would have been possible for the monetary authorities to keep up the volume of investment by expanding money supply to the extent necessary to let firms reconstitute their profit margins. But such a policy could not have gone beyond certain limits. Since we deal with the rest of the world on the basis of a fixed exchange rate, lower exports and higher imports would indeed have held back the price rise, but then our balance of payments would have got deeper and deeper into the red. With costs still going up, the position of firms would have become yet more unbalanced and the success of any policy to boost, or relaunch, investment would have been jeopardized.

To sum up, we can say that any development process deriving from an expansion of foreign demand can continue only so long as the condition upon which it depends continues, that is, so long as average costs do not rise more than abroad. When this condition comes to fail, development slows down. This began to happen in Italy in 1962 and we gave the warning signal in our Annual Report to Shareholders on 30 May of that very year. In addition to the weakening of the pull of foreign demand, investment demand also fell off as self-financing capacity declined under the impact of a cost inflation (wages, social charges, taxes).

The effects of the contraction of investment in industrial plant was aggravated by a fall in housing investment, with the result that the flow of income to these sectors lessened and with it their demand for consumer goods. Thus the impulse was propagated to the consumer goods industries, especially those making durables and semi-durables, where it depressed employment and income and specifically attacked profit margins and, hence, again investment demand. This was the beginning of a downward spiral in which each turn generates the forces for the next one.

Once we had reached this stage, average costs, which were already being pushed up by wages, began to feel the additional impact of a contracting volume of output, which means that fixed and capital costs have to be spread over a smaller number of products. In modern technological conditions these expenses are so high as to weaken the firms' resistance under the threat of labour strikes. Thus the nature of the cost rise changed as the wage push broadened out into a general upward pressure on the costs of firms per unit of product.

Official estimates put gross investment in industry at 1,750 billion lire last year, a figure only just of the same order of magnitude as the 1,786 billion of depreciation assumed in the calculation of the net product of industry. Now, the completion of new plant last year swallowed up hundreds of billions of investment, and these are included in the 1,750 billion of gross investment; it follows that many firms cannot have invested enough to replace wear and tear on existing plant. This is indeed confirmed by a survey we did on costs and revenue in selected groups of industry.

This survey covered the movement of prices for the input of main raw materials and for the output in the form of goods produced, as well as labour costs in terms of wage rates and hours worked. The intention was to calculate shifts in the distribution of value added as between wage incomes and other incomes, a residual item which includes services, interest, depreciation and taxes.

The survey suggests that a large number of firms was probably unable last year to set aside adequate depreciation allowances. Given that the categories considered in the analysis were necessarily broad sectors, each of which includes technically more advanced firms which can more easily take the shock of the wage rise without losing their economic balance, the situation of the less well equipped firms must, in fact, be worse than the average income figures suggest.

In the group of engineering industries, the prices of basic raw materials fell by 5.8 per cent between 1961 and 1964; the prices of the products rose by 12.6 per cent and average hourly wages by 45.6 per cent. Allowing for the number of hours worked and for the actual output produced, one is led to conclude that the distribution of value added in the engineering industry underwent profound changes; in the sector as a whole the share of incomes other than wage income, including in this share services, interest, depreciation and taxes, seems to have dropped by 24 per cent per unit of value added. Such a sharp fall suggests that very many engineering firms set aside no depreciation allowances in 1964. Except, therefore, for those firms which have already gone through a technical renewal process, the future competitive strength of the industry is bound to be weakened by the ageing of its equipment.

The result of the survey so far as the textile industry is concerned are equally cheerless. The industry started out in 1961 from a position where keen competition had already reduced prices very close to costs and therefore had no margin within which to absorb the rise in labour costs per unit of product. Raw material prices have increased since then by 4.1 per cent, average hourly wages by 52.7 per cent and product prices by 15.8 per cent; the industry survived by producing the same output with a reduced number of working hours, dismissing workers from the less efficient factories.

In the metallurgical industry the prices of both raw materials and products fell, output rose by 8.5 per cent, while working time decreased by 1.3 per cent. The combined effect of these adjustments probably offset the rise in average hourly wages. Total income, other than wage income, per unit of value added rose by 4.4 per cent. However, it must be remembered that during the period under consideration a lot of new plant was taken into operation, which implies a considerable rise in the capital endowment of each worker. It follows that in this sector, which is in large part government-controlled, economic balance at the level of the firm really requires a larger share of value added to be imputed to the factor capital than in the past.

In the chemical industry, the price of base materials rose by 9.8 and that of the products by 8.2 per cent; average hourly wages went up by 50.4 per cent, the volume of output by 35.4 per cent and the number of hours worked by 1.2 per cent. In spite of the signal increase in productivity, there was an income shift to the benefit of wage earners. Both government-controlled and private companies in this sector have invested heavily and need to renew plant very rapidly; we are probably not far wrong, therefore, in guessing that the industry's profit and loss accounts are not sound—that it does not earn enough, in other words, to finance the renewal of plant to the extent necessary to keep competitive.

All in all, it seems fairly safe to conclude that, apart from those sectors in which major plant investment programmes started earlier reached completion, efficiency was last year furthered especially through organizational improvements, but that industry was unable to keep up the pace of technical advance which was so marked a feature of the preceding years. To do so, industrial firms would need more funds not only for plant renewal, but also for research.

Three years ago, in our Annual Report, we already drew attention to the change in the cost/benefit ratio; in the setting which I have now described, it would appear that this change is the principal cause of the fall in the level of investment and employment.

A policy of reflating demand through public works will no doubt contribute much to the improvement of our social overhead capital, but it can have induced effects on the level of investment only to the extent that the reduction of average cost by virtue of the distribution of fixed cost over a larger volume of output is not interrupted or offset by a further rise in labour costs. Labour costs per unit of output in industry, including building, rose last year by 9.4 per cent.

The steady growth of our economy depends upon its ability to re-equilibrate the economic position of firms. This is a necessary condition for preventing the deterioration of the machines to which the workers apply the factor labour; but it is necessary also for the viability of private firms which, unlike government-controlled firms, would otherwise find their credit-worthiness impaired.

It happens that particular firms are in great difficulties because they cannot get their cost/benefit ratio back into durable balance; to help such firms by credit privileges, however well-intentioned these may be and however much designed to alleviate hardships for the workers concerned, nevertheless delays the process of adjustment to an open economy and in the last resort damages total employment. If such rescue operations were to spread, if firms were at the same time not allowed to cut down their personnel to the extent necessary to make production costs competitive, and if obstacles were being placed in the path of concentration with a view to higher efficiency—then the effect would, without any doubt at all, be to weaken our economy's resilience, not to strengthen it.

When international competition prevents the price level from rising, the effects of a cost-push inflation can be corrected most quickly by lightening the tax burden on firms. Measures of this kind were recently introduced in Italy, but their effects offset only part of the increase in labour costs. Tax reliefs in connection with depreciation, on the other hand, are not particularly effective when firms do not earn enough, as is demonstrated by the fact that in many cases actual depreciation allowances fall short of the exemption limit.

Other countries have made their own experiences with economic growth. Some of them tried to force the pace of development by an indiscriminate expansion of demand; to this end additional productive activities, which could not have been financed by the flow of saving, were financed instead by credit from the central bank, or an expansion of money supply. This policy discouraged the supply of savings, but the relatively low interest rates greatly stimulated the demand for credit, and the resulting credit expansion set in motion a rising cost-price spiral which, among other things, diminished the real value of the credits conceded. As typically happens in an inflationary spiral, monetary expansion coincided with a general shortage of means of payment. Distortion in the direction of investment, waste of resources and rising costs ultimately undermined the whole economic system. The consequences for production were initially concealed by the fact that firms, with their unbalanced cost/benefit ratio, continued to produce, but cut down on their depreciation allowances. Plant became worn and obsolete; infrastructures, which were inadequate in any case, were not properly kept up. At this point the growth-delaying effects of this kind of policy became patent for all to see.

The Need to Strengthen the Financial Structure of the Italian Economy.— An economic plan for Italy is now undergoing final revision prior to its being tabled in Parliament. In substance, the intention of this plan is to overcome the imbalances in the Italian economy without detriment to the high degree of efficiency needed to stand up to increasingly keen international competition, but on the contrary by making good certain functional and cost-increasing deficiencies precisely through the elimination of imbalances—with particular reference to a number of fundamental infrastructures. This national plan is the fruit of a great effort to assemble knowledge and look into the future, in connection also with the medium-term projections worked out within the framework of the European Economic Community; as such, it naturally engaged our closest attention as regards its quantitative targets, the means by which it is proposed to achieve them, and, more specially within our field of competence, the connected problems of finance.

Unlike other national plans, the Italian one has the distinctive feature that it tries to analyse the financial investments of the various sectors of the economy. On our own part, we thought we could perhaps add something to the knowledge of these phenomena by constructing a sort of finance matrix, a tabulation showing flows of financial assets as between different sectors of the national economy, and the resulting mutual debit and credit positions. This presentation of data helps to interpret our country's experiences of recent years and it can be seen once more that the transfer of resources from one sector to another through financial channels comes up against impassable limits.

When, in a setting of incomes and taxation tending towards greater equality, the supply of shares and bonds exceeds the willingness to save in this form, stock prices fall and the public consequently becomes even more inclined either to spend its income, or at least to hold part of it in cash or in short-term credits expressed in terms of money. In both cases the financial structure and potential of the economy suffer. This process has been going on in Italy since 1961, though it lost some of its sting last year.

While the need for long-term finance funds increased uninterruptedly, the amounts that it was found possible to raise by placing security issues with the public did not change appreciably in absolute terms, and in 1963 even fell back. More especially, equity subscriptions by Italian residents remained at a rather modest level. As a result, the amount of long-term finance funds which had to be made available through the creation of money supply has been increasing from year to year: it was 648 billion lire in 1961 and 1,326 billion in 1964. This means that long-term credits for public works and investment in plant, and not infrequently to cover the current deficits of public agencies, had their counterpart in the primary and secondary liquidities owned by millions of ordinary people. This applied to 33 per cent of the economy's total long-term requirements in 1961, and to 47 per cent in 1964.

In economies which are not the scene of such large-scale structural changes as are coming to pass in ours, significant coefficients of correlation can be established between the growth of income and the growth of primary and secondary liquid assets; it is then possible to discover whether in any given period liquidity variations do, or do not, correspond to the norm. In our economy, the interpretation of these indicators is less certain, but we can hardly close our eyes to the existence of a liquidity/income ratio strikingly higher than is usual in other developed countries. On the other hand, this ratio has been rising uninterruptedly for many years, and this suggests that there are certain elements of stability in our economy's liquidity, which make some international experts' alarm seem somewhat exaggerated. It does, nevertheless, remain a baffling feature of our economy that so large a portion of the public's financial assets is in forms which allow owners to disinvest at once and without capital loss, whenever they decide that they want to spend more.

Now, an individual's decision to spend depends not only upon his stock of money and quasi-money and upon his income flow, but also upon the extent to which he can supplement both by selling other capital assets. A financial structure is all the more efficient, the more readily it enables securities to be sold without appreciably changing the level of interest rates. But there is a limit beyond which interest rates can be prevented from rising only by means of an increase in the money supply, and this has been happening in Italy in recent years. But while the increment of money supply could be absorbed in 1962 and 1963 by the reduction in our currency reserves and by a price rise which weakened the competitiveness of our goods compared with foreign goods, conditions have changed since then. At present, the impact on our currency reserves might well be even more serious, given that they now account for a smaller proportion of primary and secondary liquidities (7.3 per cent in 1964, as against 12.8 per cent in 1961); nor could the economy tolerate further price rises.

If this is correct, we must conclude that the manoeuvering space of monetary policy at present, and in the foreseeable future, is rather narrower than it was in 1961. It would be more risky now to intervene again, as we did in the fourth quarter of 1962 and the first quarter of 1963, to stem the fall in bond prices but at the same time overexpanded the economy's liquidity. Because of the sales of bonds and shares, and because of the private investors' widespread reluctance to subscribe to new issues of either, less securities were placed with the public than in earlier years. In 1961 the public had taken up 1,120 billion lire's worth of new issues, in 1963 it took only 840 billion, compared with 2,429 billion lire of total long-term credits to the economy; this means that only one third of the economy's long-term requirements was covered with the proceeds of security issues sold to the public. As a result we experienced inflationary phenomena which shook people's confidence in the stability of our currency and kept savers away from the bond market.

There are some institutional factors which, in Italy as abroad, create a tendency to employ more primary and secondary liquid assets in long-term credits. The banking system tends to exercise its intermediary function more and more in the sense of financing security purchases with deposits commanding a higher rate of interest, and this seems to be in line with the preferences of the public, which thereby obtains at the same time more liquidity for its capital and a satisfactory yield. There are also cyclical factors which, in Italy at any rate, tend to reduce the velocity of circulation of deposits. All this goes to confirm that the most urgent problem for the authorities concerned is to organize an efficient capital market, precisely with a view to hemming in the spreading practice of bond subscriptions through the creation of money assets.

Both in gross and in net terms, the volume of security issues has increased uninterruptedly since 1961: gross new issues amounted to 1,915 billion lire in 1961 and to 2,687 billion in 1964, and the corresponding net figures are 1,432 and 1,927 billion lire. The whole increment is attributable to bond issues; so far as share issues are concerned, it should be added that a good part of them was last year absorbed by non-residents taking a stake in Italian companies. Of the net total of 1,372 billion lire new bond issues in 1964, barely 298 billion were taken up by the public and insurance companies; the rest was placed with the credit system and the Social Insurance Funds.

A growing share of total bond issues is being floated on behalf of the Treasury and by E.N.E.L, E.N.I. and I.R.I.; between them, these accounted for 46 per cent of all net issues of fixed-interest securities in 1964. Furthermore, large portions of the requirements of these agencies and their subsidiary companies were financed by short-term credit during the last two years; given that this practice can hardly continue indefinitely, their bond issues must be expected to assume a much larger scale in the future. In these circumstances it is bound to become more and more difficult to make enough room for larger issues by industrial and other special credit institutes. Their new issues have remained at roughly the same level since 1962. Industrial credit operations both increased and underwent some change in geographical distribution, in so far as the share of credits extended to industries within the regional competence of the Cassa per il Mezzogiorno rose from 49 per cent in 1963 to 61 per cent in 1964.

The forced expansion of the volume of bond issues through liquidity creation raised the ratio of bond issues to national income in Italy to a level well beyond that prevailing in other countries of the European Economic Community. Nevertheless, all economic sectors complain of an insufficient supply of capital and of the high cost of such capital as is available—and yet interest rates are already kept down artificially by liquidity creation. These last few years a strange notion has been gaining ground to the effect that the capital shortage can be made good by conceding to this or that agency the faculty of issuing bonds and by encouraging those that already have that faculty to make large-scale use of it; the problem seemed to be merely one of promising contributions to interest payments. Autonomous agencies were allowed to commit expenditure before even having raised the necessary funds. It has also been suggested, finally, that capital for long-term loans could be raised directly from the Bank of Italy. Admittedly, the central bank regards the purchase of bonds issued or guaranteed by the government as one means to control the economy's liquidity, but I do consider it as my duty to point out how dangerous the above prescriptions could be.

The draft bill of the national economic plan is based on the correct assumption that the achievement of its targets is conditioned by an income distribution consistent with adequate formation of saving. Since it is not compatible with monetary equilibrium that firms should draw in outside savings solely through borrowing, relatively more capital needs to be raised on equity issues. Thus the problem of promoting the formation of institutional savings and their placement in shares assumes increasing urgency.

It is unfortunate that so little attention has been paid to the projects to set up investment or unit trusts, which could collect part of workers' savings and more especially those corresponding to the higher earnings due to the sliding wage scale. It is also disappointing, to say the least, that the long-standing proposals for rules to govern such investment or unit trusts still await approval.

During the first few months of 1965 the situation of the capital market has been showing some signs of improvement. Large bond issues have been placed with the public, and securities of earlier issues passed from the banks' into the public's ownership without upsetting bond prices. It should be noted in this context that when the central bank, or such agencies as get their liquid funds from it, buy securities they do so, and must do so, at the stock market price. These are temporary holdings, the ultimate objective always being, and remaining, their sale to the public whenever conditions allow. But equity issues have not as yet recovered, because the market does not yet appear receptive enough. If the conditions of the stock market are to be durably improved, firms must again be given a prospect of reasonable profits, so that they can gradually rebuild their capital structure—which, as we have shown, has been impaired in many cases.

During the fourth quarter of 1964 the indices of industrial production stopped their downward move, except in building and related activities; some other sectors began to display pronounced signs of recovery, which has been continuing early in 1965. There are also some indications that perhaps the profit and loss accounts of firms are beginning to get back into better shape. But I should warn that the improvements are by no means widespread and that they appear to be slow to take effect in the economy as a whole.

Such recovery as there is certainly owes much to the reasonable attitude of workers in those branches of industry which are most sensitive to cyclical fluctuations; if the trade unions follow suit, we should be able to look forward to a consolidation of these improvements. Meanwhile, the unions have become more intransigent in their dealings with the public sector. If their wage claims should further increase the current deficits of public agencies, the latter would ultimately become yet more dependent upon credits and would thus reduce the credit supply to the private sector still more.

The claims of public agencies in general, and of local authorities more particularly, on both short-term and long-term credit increased last year. At the same time, our usual survey of 500 major companies shows that firms in the public sector received relatively more net short- and long-term credit last year than did firms in the private sector. The total amount of short-term and long-term credit extended in all forms to the public sector (including autonomous government agencies, local authorities, other public agencies and government-controlled companies) was 1,528 billion lire in 1963 and 2,230 billion in 1964, when it accounted for 69 per cent of the year's total credits.

Gentlemen,

I hope I have made it clear beyond all doubt that unless firms in the public and in the private sector alike can get their earnings back into proper balance, we can expect no durable recovery of investment demand. Investment demand will grow, and will grow only, when this condition is fulfilled.

There are forces which work towards such a proper balance, and others which work against it. There is reason to believe that the former may prevail, but that their effects will be slow.

The national economic plan assembles a great body of knowledge about the fundamental aggregates of our economy, and indeed itself adds depth and refinement to this knowledge. It should, therefore, help the makers of economic policy to assess more accurately to what extent the choice of any given priorities requires alternative objectives to be sacrificed or cut back, as well as to adapt the distribution of means to the requirements of the public and the private economy. The plan also provides for an incomes policy based on the principle that the rate of increase of money wages should be close to the rate of increase of average productivity in the system as a whole; in its turn, the profit share is to be as high as is necessary to encourage investment. Some of the big trade unions, while not renouncing the use of their bargaining strength, say that in pressing their claims they will make due allowance for the needs of an open economy —and it is indeed much to be hoped and very important that this should happen on the occasion of the forthcoming renegotiation of national labour contracts. The bond market is more receptive and bank liquidity is high, so that firms should be able to raise funds for the introduction of such technical innovations as are necessary to keep efficiency up to the standards required by domestic and international competition. Higher activity in some sectors of industrial production should help to propagate the effects of a larger volume of output, so that firms can spread their fixed cost over a greater number of products.

On the other hand, we have now all but exhausted one element of flexibility which helped to keep average cost down in 1964, in so far as the margin of wage drift and fringe benefits has dwindled away. The disequilibrating sliding scale is still with us, even though it is not expected to go up by as many points this year as it did in 1964.

In these circumstances, an effective incomes policy is a necessary condition for raising economic activity to a level where our resources of capital and labour are fully employed.

I concluded my address to you last year on this occasion by saying that the difficulties encountered by our economy were not uncontrollable. Experience has indeed shown that they have been controlled. This year I regarded it as my duty to discuss certain trends which can help us to interpret some basic problems which face us right now. The structure of our economy was resilient enough to withstand the shocks of a sharp cyclical swing, but we sustained a serious loss of income. The progress of our society will be measured not least by the extent to which economic policy succeeds in any possible future downswing to minimize such losses by applying effective countermeasures in good time and with the informed support of all the groups concerned.

Our own duty is to maintain an orderly flow of credit and thereby to promote the spread of evergrowing supplies of working equipment, not least with a view to keeping together human resources which otherwise would have to disperse and look elsewhere for employment. But it is not everything simply to accumulate more machines and so to increase the stock of useful things which serve man; those who command the machines must also be given better living conditions. If we strive for this ideal our country will advance, thanks to our citizens' working capacity and notwithstanding temporary difficulties which experience shows can be overcome; it will advance, perhaps less fast than in the fifties, but, if we govern wisely, with more benefit to the whole nation.

X. *The Note Issue, the Bank's Balance Sheet and Profit and Loss Account.*

The Note Issue.— Having begun issuing the new series of 10,000 and 1,000 lire notes late in 1963, the Bank is now distributing, since December 1964, new 5,000 lire notes with a portrait of Christopher Columbus. This brings to an end that part of the modernization programme which concerned reducing the size of the notes and printing them by more modern techniques. There remains the problem of adjusting denominations to real prewar values. It has been stated more than once in previous Annual Reports that quite apart from the development of the market economy in Italy and from real income growth, the mere price rise since 1938 requires a change in note denominations.

The failure to reshape the structure of the note issue has had two consequences: an undue increase of notes in circulation, and a strong concentration on the highest denomination. In December 1964, 10,000 lire notes accounted for no less than 85.1 per cent of the total value of banknote and silver coin circulation.

The existence of so many notes is a great inconvenience to the bank of issue (and commercial banks as well), because much useless work and expenses are involved in printing and above all in checking, as well as counting, storing and transporting banknotes. The surfeit of notes furthermore impairs strict compliance with regulations and facilitates fraud.

The concentration on the big denominations concerns all those who use banknotes and constitutes clear evidence to the effect that the kind of money we have is out of step with the volume of transactions. The bulk of paper required for even a relatively small payment brings back the problem which in the past was one of the reasons why coins fell into disuse.

Early in 1965 the Central-Bank Committee of Members of Parliament and civil servants under the chairmanship of the Minister of the Treasury formally acknowledged the inadequacy of the structure of our note circulation and decided that improvements should be introduced as soon as possible. Accordingly the Bank has put in hand preparatory work for the issue of notes for more than 10,000 lire.

Given that the purchasing power of the lira is now roughly speaking one hundredth part of what it was in 1938, there is a strong case for starting with a 100,000 rather than with a 50,000 lire note, since it is not technically feasible to bring out both at the same time.

Other considerations also speak in favour of giving priority to the 100,000 lire note. There is statistical evidence that the denominations which are a power of 10 (100, 1,000, 10,000 etc.) are much more popular than those which are mere multiples of it (50, 500, 5,000, etc.); in 1938, 500 lire notes accounted for only 15.6 per cent of the circulation, and 1,000 lire ones for 31.9 per cent. The explanation probably is that in our decimal system it is easier to do mental arithmetic that way. This being so, the Bank's purpose of bringing about a quick and drastic reduction in the number of notes in circulation would not be best served by issuing the 50,000 before the 100,000 lire note.

It is, of course, quite likely that in the absence of 100,000 lire notes, those for 50,000 lire would be eagerly taken up by the public, but the subsequent appearance of the higher denomination would displace them from the market and drive them back to the Bank's counters. We would thus be simply wasting our resources on printing, checking, distributing and soon destroying notes which failed to fulfil the monetary function for which they were created.

Capital, Reserves, and the Profit and Loss Account.— No change occurred last year in the composition of the Bank's shareholders and, hence, voting rights. On 31 December 1964, the Bank's shares were, as a year earlier, distributed as follows.

72	Savings Banks	177,647	shares	with	468	votes
8	Public-law credit institutes	54,500	»	»	141	»
3	Banks of national interest	21,000	»	»	54	»
1	Social Insurance Fund	15,000	»	»	34	»
9	Insurance companies	31,500	»	»	99	»
93	Shareholders	299,647	shares	with	796	votes
6	Savings banks	353	shares			
99	Shareholders	300,000	shares			

Ordinary Reserves, which stood at 4,955.1 million lire on 31 December 1963, rose during the year to 5,659.9 million. This was the result of appropriations of 131.6 million from 1963 profits and of 635.5 million investment income from the reserve fund itself, and a diminution of 62.4 million, which represents distribution to shareholders of part of the 1963 investment income from the fund (under Article 56 of the Statute).

Extraordinary Reserves rose from 2,664.4 million lire on 31 December 1963 to 3,028.3 million at the of 1964. This was the result of appropriations of 131.6 million from 1963 profits and of 265.9 million investment income from the reserve fund itself, and a diminution of 33.6 million, representing distribution to shareholders of part of the 1963 investment income (under Article 56 of the Statute).

Profit Appropriation. In application of Article 54 of the Statute, the Board of Directors propose, and the Treasury authorizes, the following appropriation of the Bank's net profit of 718.25 million lire for the year 1964.

	(million lire)
To Ordinary Reserve, 20 per cent	143.65
To shareholders, 6 per cent on capital	18.00
To Extraordinary Reserve, 20 per cent	143.65
To shareholders, a supplementary dividend of 4 per cent on capital	12.00
To the government, the residual of	400.95
Total net profit . .	718.25

In accordance with Article 56 of the Statute, the Board of Directors further propose a distribution to shareholders of another 34 per cent on capital, or 102 million lire, out of investment income from the ordinary and extraordinary reserve funds. This amount corresponds to 1.34 per cent of the overall reserves on December 31, 1964, and is, therefore, below the 4 per cent laid down in Article 56 as the upper limit of distribution under this heading.

THE GOVERNOR
GUIDO CARLI