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PRESENTED BY THE GOVERNOR TO THE

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Excerpts from the Governor's Concluding Remarks

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

International Monetary Problems.— Two satisfactory developments of major importance over the last year were that world trade kept expanding in spite of a somewhat slower growth of production, and that good progress was made in re-establishing freedom of international capital movements. On the other hand, the world economy suffered from imbalances which reflect the as yet incomplete state of the process of integration between the various markets that has been going on for some years as well as cyclical disparities between individual economic systems.

While the pace of economic expansion slowed down in some of the major industrial countries, like the United States, the United Kingdom and Western Germany, other economies, notably those of Italy, France and Japan, made a good recovery. In this cyclical setting several countries, at brief intervals one after the other, experienced a recurrence of the same sort of phenomena that Italy had encountered in 1964.

In other countries, too, the restrictive use of monetary policy reopened the usual discussions on the timing and adequacy of the measures adopted, as well as on the tolerability of the costs they entail in terms of a fall in the levels of investment and employment. Furthermore, the widespread recourse to restrictive monetary policies clearly was, if not the determining factor, at least a contributory cause of the rise of interest rates to heights unheard of in the last few decades. The ebb and flow of the cyclical waves in the course of the last few years have made it only too obvious how often a conflict can arise between the objectives of internal and external stability in a situation where capital movements are largely free but economic policies are not more closely co-ordinated than they are at present. Yet the slowness of progress in trying to reach an agreement on the problems of international liquidity is also delaying policy co-ordination, which must needs proceed from the same source as do responsible decisions on the creation of additional reserve instruments.

The difficulties encountered in finding a solution acceptable to all the parties concerned cannot, at this stage, be blamed on insufficient knowledge. The problem has now been explored in depth, a number of valuable contributions having recently been made to the debate. But in the discussions which have been going on at various levels, it has proved impossible to keep rational arguments separate from fanciful ones. The supporters of paper money have been opposed by those adhering to the gold myth, it being overlooked that this, too, rests upon convention.

There are some who believe that the general rise in prices should be matched by an increase in the price of gold. They seem to be unaware of the sophism inherent in an argument according to which the yardstick must be altered when the things it measures are seen no longer to have their original size. The opponents of gold have made the mistake of giving the impression that they intended to jettison the discipline demanded by the acceptance of gold in the system of international payments so as to widen the margin of discretion in domestic policy decisions, and more especially when such decisions are taken by a major country without consideration of their repercussions on the general run of other countries.

If we strip the essential problems of all the formulae in which they are wrapped up, the points of agreement and disagreement may be summarized as follows:

1) In the unanimous view of all, it is unacceptable that there should be a hierarchy of nations, of which some have the right to go on indefinitely financing their external deficit by supplies of their own currency which is generally accepted for inclusion in reserves, while others are forced to restore equilibrium to their balances of payments without delay once a deficit makes inroads into their reserves of gold and convertible currencies. The international community disclaims privilege; it demands the establishment of conditions of equality by which all its members, great and small alike, are subject to the same discipline.

2) Likewise, there is general agreement to the effect that there can be no discipline in the absence of well-defined limits to the volume of international means of payment. Some say that the way to draw such limits is to restore to gold its exclusive function as an international means of payment. According to others, the same result can be achieved by leaving the determination of the volume of international means of payment to an assembly of nations, such as that represented in the International Monetary Fund, subject to suitable adjustments in voting rights so as to give each nation a weight more in keeping with its economic importance and share in world trade.

It would seem that agreement is in sight on the merits of organizing a system of reserve creation through credits intended to finance a multilateral clearing within the International Monetary Fund. Just as in any individual country commercial banks periodically offset their reciprocal claims and liabilities and settle the difference through their accounts with the central bank, drawing on them or paying into them as the case may be, so claims and liabilities between states could be settled not only in gold and convertible currencies, but also by central banks drawing on, or paying into, accounts with the International Monetary Fund. Both the right to run up a debit balance and the obligation to accumulate a credit balance would be subject to defined limits.

Should these accounts and the underlying resources be kept apart from the accounts pertaining to the Fund's ordinary operations? Should the resulting resources be made directly transferable? Or is it better to adopt a form of indirect transferability such as is now in operation within the Fund, by which any member nation can be credited with currencies other than its own against payment in its own currency? Should credits be made repayable after a certain time when a persisting debit position is attributable either to failure to take direct measures for the re-equilibration of the balance of payments or to a preference for spending one reserve asset rather than another? These are some of the questions which the Ministers of the Group of Ten and the Finance Ministers of the European Economic Community put to the various committees of experts.

To judge by the results of the searching studies made by these experts, it would appear that there are several solutions capable of producing equivalent effects. But in any event, two prior questions must first be settled, namely, the question of the limit to be placed upon the process of the creation of international means of payment, and the question of the procedures by which these limits are to be determined—in other words, of the extent to which each country can and must have a voice in the decision.

These problems arise not only in the context of future arrangements, but also at the present time, in connection with the administration of existing reserve assets. For some time the Italian authorities have been pressing for an agreement on the joint principles that should govern reserve administration, an agreement which, while precluding the unlimited acceptance of the so-called reserve currencies, would recognize their useful function in international payments.

As regards the pound in particular, it is well to recall that the sterling balances held by the rest of the world have been pretty stable over time. In spite of the diversification of the sterling area's trade relations and the weakening monetary links between its members, the wide range of banking facilities available on the London market has maintained the pound's leading position in international financial relations. This helps to explain why the overall volume of the sterling balances has fluctuated so little, either up or down. But international trade has been expanding and will go on expanding in the future, and as it does, the world's reserves will rise; it follows that the sterling balances will come to account for a smaller proportion of world reserves. In 1948, they represented about 24 per cent of the world's gold and exchange reserves; today, they account for only 14 per cent. Supposing that world reserves rise at an annual average rate of between 3 and 4 per cent, the proportion will be only 10 per cent in ten years' time. The implication is that there is no need to take any further steps to solve the problems arising from the pound's present position in the system of world liquidity reserves; these problems will solve themselves in time.

We in Italy try to live up to our responsibilities to the international community in the way we manage our foreign position. We try to find the best combination between the foreign assets and liabilities of the private and the public sector. To this end we sometimes, in certain circumstances, allow short-term assets and liabilities to be switched into or substituted for long-term assets and liabilities and viceversa, both as between the two sectors and within each of them. In 1966, for example, and more especially in the last quarter, short-term assets of the public sector were converted into long-term assets of the private sector through private subscriptions to foreign bonds.

In our decisions regarding the composition of official foreign assets we have reconciled two purposes, namely, to protect a sizeable portion of our reserves against exchange risks and to combine adequate yields from our non-gold reserves with a high degree of liquidity.

On 31 December 1966 our official reserves amounted to 4.769 million dollars; 70 per cent of them were invested in gold or in claims expressed in gold, and of these latter 320 million dollars' worth bore interest. Another 140 million dollars' worth of claims was expressed in lire. Of the convertible currency portion, 93 per cent consisted of liquid dollar investments and the rest was made up of German marks, Dutch guilders and Swiss francs; it earned interest at an average rate of 5 per cent in the course of the year.

The 1966 balance-of-payments surplus was used in part for the advance repayment of debts by repurchasing promissory notes representing Italian debt; it was agreed, however, that this paper could be mobilized in the event of the balance of payments moving into deficit.

It can therefore be said that the purposes mentioned above are in fact reconciled in our reserves' present proportions of gold, claims expressed in gold, dollars and other currencies, short-term investments and medium- and long-term investments.

As to how large reserves need to be, this depends upon a number of variables, such as the size of gross national product, the incidence on it of foreign trade and the degree of co-ordination between economic policies. In the short run, the greater the incidence of foreign trade, the larger must be the portion of reserves held in liquid form. To illustrate this point, it may be recalled that even in a situation of tendential balance-of-payments equilibrium, such as we have today in Italy, we ran up a global deficit of 454 million dollars in the five months between October 1966 and February 1967; this corresponds to 10 per cent of official reserves and to 36 per cent of dollar reserves as of 30 September 1966.

The repercussions of our policies in 1966 upon our convertible currency reserves were accepted for the sake of preventing the rise of interest rates on the international market from spreading to the domestic market, and in the expectation that this rise would be temporary and interest rates would sooner or later begin to fall back to levels closer to those which preceded the upward movement. Events have proved us right. During the first quarter of this year interest rates declined on all the major capital markets and this has brought a relaxation of the pressures that made for an outflow of capital from Italy. It must be added, though, that especially during the first few months of this year, new pressures of the same kind were generated by apprehensions due to certain tax measures.

Domestic Economic Conditions.— Last year on this occasion in examining the prospects of a strengthening and widening of the incipient recovery, it was pointed out that the private sector was the one in which a revival of investment could originate, seeing that no appreciable increase could be expected in investment by the public sector and by public enterprises, and that there was not much hope of an improvement in building.

This view is confirmed by the results of 1966. Public investment went up moderately; public enterprises invested less; residential building remained stagnant. The bulk of last year's increase in total gross fixed investment (5.3 per cent at current prices and 3.7 per cent at constant prices) thus came from directly productive private investment, which may be estimated to have gone up by 13 per cent in real terms.

In addition to investment, the revival of domestic demand owed much to consumption which, in terms of constant prices, rose at a rate more than twice as high as in 1965. The growth rate of the foreign component of total demand, on the other hand, while still very high, suffered some deceleration.

The meeting of global demand and supply exercised no appreciable upward pressure on prices last year, a result which would not have been possible without moderation on the part of trade unions. After the exceptionally large advances between 1962 and 1964, wages in industry last year kept more in line with the productivity of the economic system. But while an increased awareness of these limitations was displayed by industrial unions in the negotiations for the renewal of major wage contracts, the same cannot be said of the labour organizations in other sectors.

The revival of total demand in 1966 after the still hesitant incipient improvement of 1965, and especially the revival of investment demand by firms, began to show up in rising employment. The employment effect, it is true, was only small, partly because of the usual time lag between changes in production and those in employment in the initial stages of both the upward and the downward phase of the business cycle, and partly because of internal reorganization within firms. According to the surveys of the Central Statistical Institute, total employment rose by 1.7 per cent between January 1966 and January 1967; if farming is excluded, the rate was higher. At the same time there was a renewed outflow of manpower from agriculture, after an interruption during the recession; the number of workers on short time progressively diminished to levels below those of 1963. The number of wage earners in industry rose by 4.4 per cent, as is confirmed also by the figures of the Ministry of Labour.

Recovery of investment demand, then, was the salient feature of the year. It had its origin not only in the decline in the margins of inutilized capacity owing to pressure from all demand components, but first and foremost in the improved profitability of firms—the prior condition of recovery, as mentioned in last year's Report.

The increase in fixed investment was most evident in machinery and equipment, the categories which had been the first, and worst, sufferers from the previous decline, which in two years had taken the relevant investment figure back by 30 per cent in real terms. This investment went into plant renewal more than into the extension of existing or the construction of new plant. The modernization process was most intensive in North Italy, by virtue of our country's industrial structure, and less so in southern regions, where capital mostly goes into the establishment of new firms.

The proportion of gross national product absorbed by fixed investment fell from 23.7 per cent in 1963 to 18.9 per cent in 1965, and it again fell in 1966, though to a much smaller extent, despite the recovery of fixed investment from the third quarter of the year onwards; no further decline is evident, however, if housing is excluded. Still, last year's ratio was well below the medium-term average and quite clearly insufficient if we are to achieve our target growth rate; the five-year programme, it will be recalled, assumes that 22.3 per cent of the gross national product will be devoted to gross fixed investment.

In the early months of 1967, some of last year's positive factors lost much of their force. Part of the cost reduction per unit of output so laboriously achieved in the course of the last two years has been offset by new wage rises as a result of contract renewals, by the government's decision to shift back to employers the whole burden of social charges of which they had been relieved by fiscalization for some time, and by new taxes required to finance government measures in aid of the flood-stricken areas. Export growth is likely to suffer from weakening demand from major European countries and from keener competition on the part of their producers in an effort to make good the shortfall of domestic sales.

The basic condition for transforming the current upswing into a prolonged phase of growth for our economy is the maintenance of a high level of directly productive investment, accompanied by the creation of adequate infrastructures.

As far as can be foreseen on the basis of available information, any further increase in investment this year will again come from companies in the private sector, especially in the engineering, chemical and man-made fibres industries. Any major contribution from public enterprises seems unlikely, at any rate if their investment in motorways is excluded. More than in 1966, on the other hand, may be expected from the public administration, if approved expenditure, in part connected with the repair of flood damage, follows the proposed time schedule.

The Capital Market.— The recovery and further expansion of production raise problems of finance which need to be considered in the broader context of the European market. While the authorities of the European Economic Community are urging members to demolish the obstacles in the way of free capital movement and are studying what adjustments might be necessary to prevent tax disparities from diverting capital flows, the individual countries are themselves pushing on with the process of liberalization. In Germany and Belgium, residents have for some time been free to import and export capital; since last January French residents have been allowed to import and export capital in any form, including bank notes. It is hard to reconcile with this trend the fact that certain circles are urging that we should raise a wall around our economy which would virtually transform it into a beleaguered fortress. This suggestion is couched in terms which seem to smack of autarchy.

Market integration has implications which surpass our imagination, and its effects pervade all fields of economic activity. In the 1950s, when natural gas began to flow through the pipeline to the industrial centres of the Po valley, this appeared to initiate an industrial renaissance that would reduce the country's dependence upon foreign sources of supply. Tomorrow the same pipeline will carry gas from African deserts and the Arctic Circle. This will not imply that we have lost our independence; it will merely mean that we are a free country which does not yield to powerful pressure groups and which gets what it needs to run the economy where it is to be had on the best conditions.

There are inherent contradictions in the attitude of those who, with the object of protecting the independence of national firms, oppose the creation of a larger market in which these firms, combined in units of a size more in keeping with the requirements of modern technology, could grow strong enough to defend themselves. Careful consideration should be given to the proposal to create a standard European type of company, whose shares would circulate freely in the countries of the Common Market and in which companies of various nationalities might combine. Other countries have in hand schemes for promotion of arrangements to strengthen the competitive position of enterprises; we in Italy are still delaying passing legislation to safeguard competition, and little interest is shown in the impending lapse of the provisions designed to encourage company mergers. These adaptations gain added urgency with the progressive dismantling of tariff barriers among the countries of the European Economic Community and between them and non-member countries, and this will apply even more in the event of an increase in the number of EEC members.

It is obvious that the problems are not merely those of the size and location of new factories and their greater or lesser degree of specialization. It is also a question of harmonizing as far as possible the laws which govern the relations between the various governments and the companies located in these countries, and in particular the open or concealed transfer of the ownership and management of individual companies or whole industries to government or other public agencies. Our constitution defines the principles limiting direct government intervention, but it would be desirable for the standards of application to be co-ordinated at the level of the European Community.

The EEC authorities believe that economic integration must necessarily be associated with financial integration, and to this end they press for measures to eliminate the obstacles which obstruct the free transfer of long- and short-term capital. Some time ago the EEC authorities put in hand a study of the principles which it would be desirable to see incorporated in legislation governing the taxation of income from securities, so as to remove disparities that distort capital movements. To do away with these disparities would impose yet another constraint upon the autonomous decisions of individual governments; but governments cannot at one and the same time aim to create a European capital market and refuse to accept a uniform system of taxation of income from securities, suitably co-ordinated as regards methods of assessment.

In the preparatory studies on the taxation of income from securities, the EEC authorities seem to favour a system which does not stimulate an outflow of capital to third countries to the detriment of economic development in the Community. Under the solution proposed in these studies, any system of automatic disclosure of dividends and interest would be precluded and any withholding tax on them would be regarded as provisional, allowing the taxpayer to choose between accepting it as a final settlement of his tax liability or deducting it from his personal tax. It may be pointed out that such a system is not very different from the one that was introduced in Italy in 1964 and abolished last February, when the 1962 system was restored with some modifications.

It cannot be said that our country's much debated and so often changed legislation in this field ever has helped, or is helping, to encourage equity investment; yet there can be no doubt that increasing equity investment is an objective with a high priority.

In the four years 1963-1966 manufacturing firms incorporated as joint stock companies whose shares are quoted on the stock exchange invested more than 2,400 billion lire gross and almost 1,600 billion net. Of the quoted companies only 23 increased their paid-up capital; the nominal value of their new share issues was 102 billion lire; in all, new money from shareholders amounted to 127 billion lire, including instalments called up on earlier capital increases. This sum accounted for barely 5.2 per cent of the companies' gross capital formation over the four years, viz. 5.6 per cent in 1963, 2.7 per cent in 1964 and 6.6 per cent in 1965. From incomplete figures for 1966 it would appear that the proportion last year worked out at 7.9 per cent, but this is reduced to 1.3 per cent if we exclude payments in connection with the capital increase of ANIC [a petrochemical subsidiary of the public holding company ENI].

In contrast to the scanty activity in the new issue market for shares, bond issues grew to such an extent last year that the Italian issue market moved into first place in Europe. Expressed in dollars, net bond issues amounted to 5,266 million and thus broke the previous European record for the period 1961-1966, which was achieved by Germany with its 4,327 million dollars' worth of bond issues in 1965. Total net security issues amounted to 8.6 per cent of gross national product in Italy last year; the average for the rest of the Common Market was 2.3 per cent. Bond issues were floated on better terms in Italy than elsewhere in the Common Market, and the amount taken up by private subscribers was satisfactory: 48 per cent compared with 32 per cent during the preceding four years.

Gross issues of fixed-interest-bearing securities totalled 3,897 billion lire in 1966, and their placement was facilitated by the copious flow of liquid funds consisting of loan repayments and interest—together 1,668 billion lire. Fixed-interest securities accounted for 86 per cent of all new security issues in 1966. Net fixed-interest security issues totalled 2,821 billion lire, of which 67 per cent were floated by or on behalf of the Treasury and by the public enterprises ENEL, ENI and IRI; the rest was issued by industrial, land and agricultural credit institutes. Companies of the private sector made no issues. It is only fair to add, however, that part of the sums raised by the public sector has been or will be transferred to the private sector by such means as for example the plan for agriculture (the Green Plan) and electricity compensation payments, or through the channel of special credit institutes.

Some highly interesting points emerge from retrospective comparisons. The nominal value of fixed-interest-bearing securities outstanding was 6,800 billion lire at the end of 1961 and 15,900 billion at the end of 1966. At the former date, 59 per cent of them were owned by individuals; by the second date, the proportion had dropped to 45 per cent and the proportion in the hands of banks had risen correspondingly. Over the same period, the market value of shares in circulation declined from 20,800 to 18,400 billion lire. The proportion owned by individuals, companies and institutions of Italian nationality decreased, and the proportion registered as foreign holdings rose from 10 per cent in 1961 to 18 per cent last year. Shareholdings of individuals in Italy accounted for 37 per cent of the total in 1961, 40 per cent in 1963 and only 33 per cent in 1966. Since, however, the figure is a residual estimate and includes the holdings of associations and foundations, the real decline was probably even greater.

If one looks at what actually happens to such shares as change hands on the occasion of the monthly settlements at stock exchanges, it will be seen that part of these shares is transferred from private to public portfolios—a sort of surreptitious nationalization. The pension fund of the Bank of Italy proved another haven for equities sold by private owners immediately before and after the publication of the new law on the withholding tax last February.

These kinds of developments happen more or less all over the world, but in Italy they are accentuated by disparities in tax treatment. On all the great capital markets new issues have tended to assume the form of bonds, even the issues of private companies. But this is no argument in support of a discriminatory system which impedes share issues, especially in the case of a country such as ours, where the self-financing ratio is appreciably lower than elsewhere. Nor can we escape the conclusion that this tendency ultimately strengthens the groups that effectively control firms incorporated as companies, in so far as it affords these groups an opportunity to increase their own equity holdings by buying shares from small savers at prices determined by the decisions of these very same groups. Since companies are obliged to make redemption and interest payments in accordance with the terms of their loan issues, without any possibility of adjustment to changing market conditions, they are faced with two alternatives. They must either accept the resultant wide fluctuations in their financing margins, which creates difficulties for investment planning and the implementation of investment programmes, or make changes in the number of people they employ, which disrupts the absorption of new entrants to the labour force.

The government is now preparing a tax reform bill which incorporates modern principles such as those underlying the tax systems of the Western countries. Since it is proposed to abolish all separate taxes on incomes and to replace them by one single, progressive, personal tax, it can in theory be argued that all incomes should be counted as part of each taxpayer's total income and that suitable means of assessing it should be provided. But, while the full application of the principle that taxation should be personal and progressive is the ideal aim of the reform, it must be remembered in pursuing this aim that our economy must make its way in an open market.

As regards the tax treatment of interest on bonds and on deposit and current accounts with banks and the Post Office, the reform bill precludes any form of disclosure of the recipients' names. It may be inferred from an official statement that interest on bonds issued not only after, but also before the new law comes into force will not enter into the computation of the recipients' income and will therefore not be subject to the progressive tax; furthermore, it is understood that the government intends to introduce transitional provisions by which the holders of bonds issued before the reform takes effect will be guaranteed the receipt of interest in the actual amount indicated on the coupon and that nothing will be done to ascertain the names of the holders.

Care will also have to be taken to make sure that the new tax treatment be conducive to a proper balance between the fixed-interest and the variable-interest sections of the security market, and between our own system and that of the countries with which our market is most directly linked, so as to avoid any distorting effects on capital movements. This applies not only to the tax system itself, but more broadly to the institutional framework; in this connection, I want to draw attention once more to the harmful consequences of our lack of open-end investment funds. Such funds have assumed fairly sizeable proportions elsewhere in Europe and the fact that these operate in Italy constitutes an additional handicap for our capital market.

The transition from the old to the new tax system will require the greatest care so as to avoid any adverse effects on production. In particular, if taxes of known yield are replaced by taxes of uncertain yield, we shall need more information about the distribution of incomes according to size with a view to fixing tax rates which meet all the various purposes of the reform, and first and foremost that of the continuity and adequacy of tax revenue. Otherwise, if the government subsequently varies the tax rates, as it would have the possibility of doing under the reform law, this might cause fluctuations in the economic system prejudicial to the achievement of the rate of growth envisaged in our economic programme.

The receptiveness of the market for bond issues enabled special credit institutes last year to raise the amount of their medium- and long-term loans outstanding by 1,015 billion lire, compared with 797 billion in 1965. Industrial credit institutes alone were responsible for 569 billion lire of the additional loans, as against 473 billion in 1965. The fact that production recovered chiefly in industry and most sharply in the northern regions had a bearing on the composition of loans; the ratio between loans to industry and those for public works shifted in favour of the former, and the share of Southern Italy, which was 52 per cent in 1965, dropped to 13 per cent.

This latter contraction had a lot to do also with the time lapse pending implementation rules for the new law concerning the activities of the Cassa per il Mezzogiorno, and it assumed larger proportions in the mainland regions of the South. The explanation is probably that in the islands new loans were largely granted in connection with a few large factories already under construction, whereas on the mainland loans were more widely spread among small firms. Despite all the special credit facilities, newly established small and medium-sized firms encountered great difficulties in this connection, which in some cases were aggravated by the inexperience of the promoters.

Subsidized Credit.— The greater part of the loans extended by industrial credit institutes falls into the category of subsidized credit, which in 1966 accounted for 578 billion lire out of total new loans of 1,081 billion. The proportion seems bound to increase in the future; at the end of last December, the institutes had commitments in respect of subsidized credits amounting to 1,556 billion lire, whereas their commitments in respect of ordinary credits came to barely 467 billion.

Subsidized credit is one of the incentives designed to promote economic development in Southern Italy, and is intended to offset some of the higher costs which firms incur in the South because of insufficient infrastructure. The size of the subsidy depends on the extent of the costs it is meant to compensate. But the question arises whether, in the long run, it may not be wiser to rely less on credit facilities and instead to go ahead faster with the creation of the infrastructure for which these facilities are a temporary substitute, and also to step up the intervention of public enterprises with a view to developing new production with a high research content.

The proliferation of subsidized credit makes those who apply for it believe that they have a right to it, and weights the decisions of the special credit institutes responsible for its administration in the direction of the social utility of the proposed investments. By a sort of process of selection in reverse, competition among credit institutes of different backgrounds works to the detriment of those with longer experience, which are better equipped for a critical assessment of borrowing firms from the point of view of their capital, financial strength, earning capacity and organization, and to the benefit of those institutes which are more inclined to grant every request, trusting that it will be approved by the authorities responsible for the decisions on interest equalization grants.

More and more, subsidized credit is assuming the character of public assistance; its growth gives sustenance to the conviction that this is the way to solve local problems, and hence the credit institutes' lending becomes increasingly subject to interference, which impairs the objective conduct of their business. In their relations with political authorities, the credit institutes find that the latter, rather than limiting themselves to general economic policy directives, also extend their influence to questions of detail and steer the use of credit toward the solution of incidental problems.

Instead of being a means of strengthening the competitive position of Italian industry, subsidized credit is used to bolster rearguard positions in an attempt—condemned sooner or later to prove vain—to keep alive firms doomed to succumb to domestic or international competition.

Economic circles are pressing for an extension of these credit facilities so as to increase their field of application from the financing of fixed investment to that of stocks and even to working capital. Ultimately the operations of ordinary banks are suffering, because the latter are more and more coming to trust that the borrowing firm will repay somehow or other with the help of subsidized credit or other public credit facilities.

Interregional and regional credit institutes thus have to devote a growing part of their activity to handling the administrative formalities connected with grants from the central or regional government, so that in the end they themselves come to resemble offices of the public administration. Their banking character grows fainter; their competitive capacity fades; their public bias is accentuated, and this is bound to lead to a change in the controls to which they are subject. But such controls become more difficult to exercise owing to the credit institutes' increasing subordination to regional interests, and this is happening at the very moment when economics and technology alike demand that production units should be larger and that the economy should leave provincialism behind.

Our Report for 1963 outlined the transformations in course in the socialist economies, and more particularly in the Soviet Union. Decentralization on a regional basis has been abandoned, and the Soviet economy is now being reshaped through subdivision into enterprises with growing independence and the possibility to choose factor combinations in the light of indicators based on comparative factor costs. These current reforms have been widely publicized, and this is not the place to discuss them in detail; it may merely be pointed out that the spirit of the reform is that enterprises should be answerable for their liabilities with their own assets, that proceedings for insolvency can be instituted against them and that the state provides no guarantee whatever. The very first reform measures lay down that annual profits may be allocated to the capital funds of enterprises, that capital invested must be reconstituted by setting aside adequate depreciation allowances, and that enterprises may draw on bank credit to the extent of their capacity to repay.

Some further considerations regarding the excessive spread of subsidized credit are suggested by certain aspects of foreign trade. The increasing flow of exports to developing countries on deferred payment terms is having adverse effects on these countries themselves. The accumulation of redemption and interest commitments is a heavy drag on the balance of payments of countries which, for some years to come, are most unlikely to earn sufficiently large surpluses to service their mounting debts.

One might ask whether, instead of giving surreptitious assistance to developing countries—for funds that have the appearance but not the substance of credit must be considered as such—it would not be preferable if we, for our part, were to utilize state budget resources to grant aid. This would not alter the fact that we are withdrawing real resources from domestic use, but Parliament would then decide on the volume and timing, and public opinion would know about it. Actually, export refinancing is, in its end effect, tantamount to financing the budget, which would otherwise have to bear the consequences of insolvency on the part of countries to which goods have been exported on deferred payment terms.

A decision of this kind would, furthermore, be in keeping with our commitment, under our economic plan, to allow some 1,000 billion lire for aid to developing countries in the course of five years; as things are at present, neither the real nor financial implications of this commitment are at all clear.

Similarly, export credit insurance, which was originally meant to afford exporters protection against the possibility that the transfer of money paid by the importers might be prohibited, has gradually come to cover also commercial risks. Official guarantees have become more common in importing countries as well, so that neither exporters nor importers have any real interest left in the intrinsic soundness of the transaction. Certain practices have sprung up whereby the exporter and the importer collaborate to obtain from the latter's government authorities the necessary guarantee for the completion of the transaction. Once again the special credit institutes play no more than an administrative part, their sole function being to check that all the papers are in order.

The result of all this is that countries to which such subsidized exports are sent suddenly see industries springing up without necessarily any reference to market demand or to any co-ordinated and comprehensive government plan. Sometimes these new industries get into difficulties because local consumers refuse to buy their products and prefer imported ones enjoying the same credit facilities thanks to which the machines making the local products were imported in the first place.

Policies to promote the economic development of the less developed countries have been in the forefront of world discussions for ten years, and we have learnt enough to know what complex problems emerge when it is a question of operating within systems that require profound institutional changes.

Indeed, the task of the industrial countries cannot be expressed in terms of money alone. What is needed is that European civilization, whilst respecting native traditions, should help to bring about the necessary transformations of institutions and habits. These transformations must be guided by ideals of social betterment without calling forth discontent, which experience has shown to be conducive to forms of government opposed to these very ideals as also to the forces that foster those processes of social reorganization on which material progress depends.

The Activities of the Banking System.— Our policy in 1966 was to enable expanding production to be financed on the basis of falling short-term and stable long-term interest rates, despite the fact that both were rising steeply on some of the markets with which ours is most directly linked. We put this policy into effect firstly by controlling bank liquidity, and secondly by encouraging competition among banks; to this latter end, we issued instructions conferring upon the largest banks the faculty of operating also in localities where they have no branches of their own. The interest rates charged for lire loans by nation-wide banks diminished on the average by about one fifth of a point in the course of the year and at the end of 1966 were between 7 and 7 ¾ per cent.

Increased competition among banks is intended to stimulate a process of reorganization which will make banking firms assume a size appropriate to the conditions of an integrated economy. It is, of course, up to the central bank to make sure that competition does not degenerate into aggression by big banks against small ones, leading to the destruction of the latter.

With this in mind, a careful survey has been made of the profit and loss accounts of banks with networks in more than one region which have been authorized to operate also in provinces where they have no branches. Although the margin between borrowing and lending rates narrowed in 1966 while personnel costs and tax expenses increased, the banks in this group were able both to make appropriations to reserves of amounts at least as great as in previous years and to pay dividends on their capital, thanks to the expansion in the volume of their business and to their active intermediation in the security market both at home and abroad. Allocations to staff retirement funds, however, are still inadequate; and it must be added that the banks' rôle as intermediaries in the bond market may well fail in the future to expand as much as it has done recently, to the inevitable detriment of profits.

Taking the banking system as a whole, credits of up to 100 million lire account for 46 per cent of the total amount of credit outstanding, those between 100 and 500 million for 21 per cent and those between 500 million and 1 billion for 8 per cent. The average amount of individual credits in the up to 100 million category is 3 million lire. These figures go to show that the present structure of the credit system responds quite well to the requirements of credit distribution in an economy such as ours, where medium- and small-sized firms still predominate. The same conclusion may be drawn from an analysis of the relationship between the movements of production and ordinary credit, an analysis which testifies to the flexibility with which credit is adjusted to the various branches of economic activity.

An examination of the distribution of loans according to their amount shows that the various categories of banks as a rule operate in different sectors of the market, while at the margin there are common areas where competition is keener. In the case of the twelve largest banks, credits of up to 100 million lire account for 38 per cent of total credit outstanding; this proportion is 52 per cent in the case of the 38 next-largest banks, and 63 per cent in the case of all the others as a group. In the category of public-law credit institutes, credits of more than 10 billion lire account for 12 per cent of total credit outstanding; for banks of national interest the figure is 7 per cent. The high proportion of credits exceeding 10 billion in the assets of public-law credit institutes is explained by the fact that they do more business with the public administration, and more especially with local authorities.

Small credits are seen to fluctuate more in individual amount, upward or downward, than do large credits. Furthermore, there is a general shift of credits toward the larger size classes; in particular, some local authorities, unable to repay previous credits, add such new amounts as they borrow to the total already outstanding in their name. This creates situations of some concern to the Bank of Italy; it often happens that toward the end of the month the Bank has to authorize new loans to this or that municipality for the mere sake of public order. Provisions are now under examination by which local authorities would be financed through the medium of the Central Post Office Savings Fund; while this would solve the problem of the local authorities' indebtedness to the banks, it would aggravate the problems deriving from the growing volume of bond issues. Recently, the State Railways were given access to bank credit, and this, too, will have to be carefully limited by the competent authorities.

Portfolio investments and credits to public institutions and government-controlled companies did not prevent the banks in 1966 from giving more help to medium- and small-sized firms, which contributed most to the investment recovery. Banks and banking associations together last year increased the total of their loans outstanding by 2,027 billion lire, compared with 933 billion in 1965. The public sector absorbed 343 billion, or 17 per cent of that total, as against 255 billion, or 27 per cent, in 1965. Large companies of the private sector, as a group, borrowed virtually nothing, so that 1,672 billion lire, or 82 per cent of last year's increment, went to medium- and small-sized firms, including households. The banking system's security portfolio increased by 1,340 billion lire to reach a total of 5,516 billion on 31 December 1966; of this amount, 3,135 billion's worth was freely disposable.

The plentiful offerings of government and government-guaranteed bonds (including bonds issued by the Credit Consortium for Public Works to cover loans to the Treasury) as well as of bonds of public enterprises, and their stable prices, obviously did much to attract the liquid funds of the banking system. It must be recognized that the continuous expansion of the volume of public loan issues, coupled with the maintenance of stable bond prices, is bound in the long run to alter the structure of the banking system. The effects are seen on the side of assets no less than of liabilities; in both cases, bonds tend to displace normal bank business. Bonds accumulating in huge amounts in bank portfolios tend to displace loan operations, especially those involving higher risks. On the other hand, if bonds are almost as liquid as deposits, this is bound to influence the behaviour of savers; those banks which have sections authorized to issue bonds contribute to the process every time they place their own issues subject to a repurchasing clause based on an agreed price.

As the public gradually became aware of this assimilation of bonds to deposits, people developed the habit of drawing down deposits in order to invest in bonds. The banks have been counteracting this tendency by raising the interest paid on deposits; at the same time they have had to protect themselves against the attraction which high deposit rates abroad were exercising on deposits. The ease with which such funds can migrate from one market to another has been reflected in large-scale capital transfers, partly in the form of bank note exports.

In these circumstances the authorities did not see much point in intervening to hold back the rise of interest rates on bank deposits. Certainly, competition among banks became keener and far more deposits came to enjoy interest rates in excess of those laid down by the interbank agreement, although, in annual average terms and for the banks as a whole, the overall cost of deposits did not go up by more than one quarter of a point. Competition was, and still is, keenest for deposits of the public administration and for those of large companies in the public and the private sector, but it extends also to deposits of medium size; the only exception are the smallest deposits, especially in small towns. Tendencies of this kind are evident also on markets better organized than ours, and they have a certain aspect of distributive injustice; but on the other hand small savers do have the advantage that the ample supply of bonds at stable prices offers them profitable investment outlets without exposing them to the risk of substantial losses should they suddenly need to sell their holdings.

Recent experience on the world's largest money markets confirms how hard it is to enforce controls on interest rates when there is disequilibrium between the demand for liquid funds and their supply, when markets are intercommunicating, or when the effects of the tax system exert additional upward pressure on deposit rates. Cut-throat competition among American banks and between them and non-banking institutions, as well as the increase in deposits enjoying higher rates than are fixed by the authorities, both go to show how meagre are the results of coercion.

This is not meant to imply that the attitude of the authorities should be one of indifference. But the way to get the most effective results is not coercion, but rather to influence the behaviour of banks via changes in the profit calculations that govern their activities. To this end it might be expedient to adapt the tax system to the need of keeping capital market rates and deposit rates distinct, even though connected.

On the occasion of the tax reform, it might be possible to strengthen the chances of controlling the rates on short-term and long-term funds and of maintaining an institutional demarcation line between them by introducing two separate, and different, tax rates for the proportional tax to be deducted at source from interest on bank deposits, by a procedure similar to that now applied to income tax category A (income from capital). When banks pay deposit rates not exceeding the ceiling rate fixed by the monetary authorities, the lower tax rate should be applied; beyond this limit, where the banks would in effect be invading the sphere of the capital market, the tax rate should equal the higher rate applicable to bond interest. Pending the tax reform, the tax rates for income tax category A might be differentiated and it might be provided that the tax deducted at source from interest on deposits should be allowed against the banks' taxable income in the first case only.

In this manner the tax system would create an inducement for banks to keep interest they pay to their depositors within the maximum limit indicated by the monetary authorities, and at the same time it would strengthen the mechanism of control on the truthfulness of the banks' declarations. It would be the responsibility of the banks to show in their annual tax returns how much of the interest they have paid out is subject to the one tax rate and how much to the other, and the sanctions of the law would be applicable to any untruthful declaration. In speaking of a maximum limit, what we have in mind is a system by which, anywhere up to this limit, the banks would be completely free to decide what rates actually to pay; nor would it preclude interbank agreements to the extent that they are compatible with Italy's Common Market obligations.

This system might be combined with the abrogation of any restrictions on lending rates, and in addition with freedom to pay interest at market rates on interbank accounts. The result would be a more rational distribution of financial resources. A money market would be created through which resources would be channelled to those prepared to pay most for them. With communication so wide open between the domestic and the international market, the funds could be distributed over a much larger area, so that domestic interest rates would be more directly linked to those abroad. A limited supply of Treasury Bills would give the banks an optional investment outlet for all or part of their liquid funds, and oscillating interest rates might create the conditions of a more flexible manipulation of the discount rate.

With the progress of integration among money markets, official controls themselves will surely have to assume forms compatible with the principle that a firm's efficiency is measured by its profits; profits would thus fulfil the function of replacing human judgement, which may be arbitrary, by the evidence of results. But results can be a meaningful indicator only when they are achieved in an institutional framework which ensures equality of conditions for all who compete with each other in the performance of a service of interest to the whole community. To this end all banks must be subject to the same discipline, regardless of whether they are incorporated under public or private law.

The controls exercised by the Bank of Italy are not, and should not be, like those to which the expenditures of the public administration are subject. A bank, whether it is public or private, must adapt its behaviour to changing market conditions; it must be free to grant or refuse credit to individual borrowers in the light either of a reasonable assessment of their credit-worthiness or of such guarantees as may be offered, or both. In the various current discussions on credit policy, one can often hear the criticism that the guarantees usually required by banks are allegedly excessive, and this is coupled with the recommendation that credit should be granted rather on the basis of the banks' own judgement regarding the ability of the would-be borrower. But such judgements are human, and even if they are made with the greatest possible shrewdness, cannot be, and must not be presumed to be, infallible. To strive for infallibility in the banking business would end up in paralysis.

It is part of our watchdog function over the banking system also to examine what sort of internal organization is best for sound business conduct. This we do methodically, and with great care set right any situation found to be wanting, especially if it is due to management coming up against the characteristic obstacles of economically less developed areas.

The abrogation of restrictions upon the activities of individual banks and the more direct intervention of foreign banks are intensifying competition in the banking sector, and this demands of the monetary authorities the creation of an institutional framework in which banking can be carried on in conditions of equality. In Germany and France banks are free to set up branches without prior authorization; in Germany both lending and borrowing rates are free, and in France lending rates.

It is a condition of effective competition that bank managers should be chosen on no consideration other than their competence. In the case of public-law banks operating throughout the country these choices must be made by the government, which is answerable therefore to

Parliament, and they must not depend upon any prior agreement between the government and the regional, provincial or municipal authorities. Finally, there is a case for encouraging rotation in managing boards by regulations laying down maximum limits for directors' terms of office.

It will be up to Parliament to adapt the law governing the credit system to the conditions of wider competition within the European Economic Community. This appears even more urgent if, as may be hoped, the United Kingdom joins the Common Market, for Europe's most efficient banking and insurance system would operate more directly in the Community. A uniform discipline for the banking profession is a thing to be introduced in steps, but in the meantime nothing must be done that is not in line with this end.

The central bank will remain responsible for such changes in the structure of banking firms as may be necessary for the latter to hold their own in the face of increasingly direct competition with the banks of foreign countries, where mergers have taken place precisely with a view to enhanced efficiency.

Monetary and Fiscal Policy.— At meetings of those who are responsible for monetary policy two sorts of complaints are commonly heard: governments are not as quick as might be desired in adapting the volume of public expenditure and the methods by which they finance it to the objectives of tendential balance-of-payments equilibrium and price stability; and the effectiveness of monetary policy measures is hampered in markets where funds are freely transferable.

Fiscal policy has come more into the foreground as a result of recent experience in the United States, where the judicious tax cuts in the years since 1961 are now regarded as one of the factors which helped to promote and sustain expansion in conditions of satisfactory price stability.

But this same example also teaches us that when it is a question of restraining an incipient price rise, the instruments of fiscal policy do not work fast enough and therefore need to be supplemented by the tipical measures of monetary policy. Moreover, the Americans do not seem to have discovered a policy mix of fiscal and monetary measures such as to temper the harshness of the latter. The rate of increase in both long-term and short-term credit declined in the second half of 1966 to about one third of what it had been during the first half of the year, with far-reaching effects on the capital and money markets of the rest of the world, for the resulting huge capital movements exercised heavy pressure on the currency reserves of more than one central bank.

The discussions concerning the limits within which, in any particular case, it would have been expedient to contain the use of monetary policy measures confirm that the various forms of fiscal and monetary policy need to be considered not as mutually exclusive alternatives, but as complementary to each other, both helping in different degrees to achieve the objectives set by parliaments.

The analyses contained in our Annual Report this year do not hold out much hope of fiscal policy instruments being effectively used in Italy, as elsewhere, to regulate the economy.

The total demand for credit on the part of the public administration and the autonomous government agencies to cover their deficits in 1967 is expected to be more than 3,000 billion lire. The requirements of the government itself and of the autonomous agencies can be deduced from their respective initial budget estimates, adding expenditure under special laws to be included subsequently in the revised budget estimates. The amount involved is about 2,000 billion lire; assuming that no changes occur in budgetary arrears and that no major expenditures are carried forward, this sum will be reflected in the Treasury's cash budget. Local authorities must be expected to run up a total deficit no smaller than in 1966 (700-800 billion lire). Recent official statements suggest, finally, that the administrative budgets of the main Social Insurance Funds will show a deficit of about 700 billion lire, of which some 500 billion or so will have to be financed by credit if we make allowance for presumable allocation to reserves; here again, actual requirements will depend upon the time lag between the administrative and the cash budget.

Of the total requirements of 3,000 billion lire, at least 1,200-1,300 billion will have to be financed by bonds issued by the Treasury and the autonomous agencies, under the terms of the legislation authorizing the corresponding expenditure. In addition, it may become necessary to cover also expenditure to launch the second five-year phase of the State Railways' modernization programme, and the Central Post Office Savings Fund may also make claims on the market should it be authorized to float direct bond issues. It is, of course, possible that not all the expenditures to be financed in these ways will actually be disbursed during the year; yet the full amount indicated will have to be raised on the capital market, because the government cannot include the expenditures concerned in its budget unless the funds for their coverage are actually at hand.

The rigidities which hamstring fiscal and monetary policy alike derive not only from the accumulation of expenditure commitments on the part of the government, local authorities, Social Insurance Funds and autonomous government agencies, but also from the size of the special credit institutes' loan commitments in connection with such investment programmes of firms as are already in hand. Furthermore, we must add commitments for exports on deferred payment terms in connection with plant construction abroad, which commitments will have to be honoured in the course of the next few years. We have tried, in our Report, to work out the total amount of expenditure commitments not liable to adjustment in the light of market conditions, and we have come to the conclusion that they put further constraints upon monetary policy.

It remains to be added that the manipulation of tax rates and its effectiveness (leaving aside any reflection on the behaviour of taxpayers in meeting their tax liabilities) are subject to the existence of reasonable balance between the public sector's revenue and expenditure. When, as in our case, the total deficit of the government, the autonomous government agencies and local authorities keeps growing year by year, it is hard to see what leeway is left to fiscal policy, since the government is, and must be, for ever in search of new revenue, so as to diminish the gap which has to be filled by voluntary saving.

Recognizing these limitations, we have made an effort to refine the instruments of monetary policy. An examination of the methods used in the control of bank liquidity shows the growing importance assumed by public debt operations and by bond operations carried out either directly by the Bank of Italy or by the banking system with monetary means released from time to time by the Bank of Italy. In view of the public sector's growing deficit, which is not amenable to countercyclical co-ordination with the surpluses or deficits of the other sectors of the economy, the monetary authorities cannot regulate liquidity creation without altering the methods by which the public sector is financed. This involves increasing or decreasing the portion of the deficit that is covered by monetary means and, as a supplementary measure, selling or buying securities.

Among the autonomous factors which go to determine changes in bank liquidity, the most important in 1966 was the Treasury deficit, which created liquidity in an amount of 1,867 billion lire. The current surplus in the balance of payments expanded liquidity by another 867 billion lire; deducting capital movements the net liquidity-creating effect of the foreign sector works out at 418 billion lire. The other sectors absorbed 83 billion lire of bank liquidity.

Public debt operations and open market operations by the Bank of Italy reabsorbed liquid funds in an amount of 1,368 billion lire, but other security operations, including security allocations to compulsory bank reserves, had a liquidity-creating effect of 666 billion lire, so that on balance the net effect was to reduce liquidity by 702 billion. Rediscounts and the Italian banking system's foreign operations were of limited importance; the former created liquidity in an amount of 172 billion lire, and the latter absorbed 182 billion. In all, allowing also for minor items, intervention by the monetary authorities last year reduced bank liquidity by 715 billion lire.

The combined effect of the autonomous factors and of intervention by the monetary authorities was to increase the monetary base by 1,487 billion lire and, allowing for 806 billion absorbed by the public, to expand the banking system's liquid funds in sufficient measure not only to finance the credit expansion described above (together with an increase in deposits which required 586 billion lire to be paid into compulsory reserves), but also to leave additional liquidity of 95 billion with the banks themselves.

From one end of 1966 to the other the public's liquidity increased at a rate lower than in 1965, but considerably higher than the rate of increase of GNP at current prices. Stable prices and steady quotations, induced private investors to take up more bonds than before, viz. 1,249 billion lire as against 723 billion in 1965. Nevertheless, the banking system's bond subscriptions rose in 1966 to 42 per cent of deposits received in the course of the year, compared with 36 per cent in 1965.

It was one of the objectives of monetary policy to maintain interest rates on the capital market at a level consistent with the aim of encouraging investment. This had important implications for the choice of the channels through which the central bank injected liquid funds into the market or reabsorbed them. Operations in government or government-guaranteed securities were on a large scale; this applies equally to the Bank of Italy's direct operations and to those transacted in increasingly close collaboration with the banks and more especially with the Central Institute of the Savings Banks. The Bank of Italy bought and sold paper of the kinds mentioned in an amount of close to 800 billion lire in 1966, and another 1,380 billion lire's worth or so were turned over by the Central Institute of the Savings Banks.

In formulating decisions of monetary policy account has been taken not only of changes in the supply of money and quasi-money, but of the whole spectrum of financial assets. This meant enhancing the effectiveness of the provisions which enable switches to be made between the various categories in response to the public's autonomous preferences. In certain circumstances the public withdraws from the security market and puts its money into savings accounts; for this reason it was decided, in the second half of 1965, to increase the flexibility of the market by freeing savings banks from the obligation to tie up the compulsory reserves required to cover an increase in savings deposits either in accounts with the Bank of Italy or in Treasury Bills, and allowing them an option to purchase mortgage on agricultural paper instead.

By encouraging investment in mortgage bonds, the monetary authorities influenced the pattern of investment. Thus 559 billion lire was channelled to residential building, an amount far in excess of the last few year's figures.

The chances of success of a policy such as I have outlined depend upon the fulfilment of a number of conditions, among which I would emphasize two in particular.

The first is the existence of an institutional framework suitably adapted to the development targets of our economic programme and immune from sudden incidental changes, for such changes might modify the propensity to save and the pattern of the use of savings in ways not susceptible of correction by monetary measures. In an open market, for example, certain amounts of savings might be transferred abroad regardless of their yields.

The second condition is that the supply of public securities should not assume proportions such that they cannot be placed at interest rates compatible with our need to encourage investment. The mounting deficit in the public sector's administrative budget makes it more likely that the cash deficit will also be much larger. In the event of these requirements being covered by bond issues on the capital market, the sudden growth of the cash deficit would tend to depress bond prices. Any attempt to prevent a rise in interest rates might lead to the creation of more liquid assets than is compatible with price stability, with more immediate effects when the system is working at nearly full capacity.

In other words, we cannot close our eyes to the fact that monetary policy, when asked to achieve contradictory purposes, ends up in a dilemma. The monetary authorities might refrain from intervention and let security prices slide; it would then become more difficult to place new issues, but in that case the monetary authorities might have to finance the public sector's deficit directly and so to widen the monetary base. Should they decide, instead, to intervene in order to keep interest rates down, by subscribing to such portions of new issues as exceed demand at existing rates and by encouraging the banks to do the same on a large scale, the result would still be that these securities themselves would, in substance, become part of the monetary base.

At present a large proportion of the portfolio investment of the banking system is tied by the monetary authorities, and the bulk of free securities is owned by savings banks, which have an institutional bias toward this kind of asset. I would add that, in accordance with the directives of the Joint Ministerial Committee on Credit and Saving, the central bank stands ready to take resolute action, should the circumstances so require. There is reason to believe, therefore, that, in the short run, we shall escape the dilemma of having to choose between alternatives which would imply sacrificing the continuity of our country's development, but in the longer run, such continuity will necessarily require the fulfilment of the conditions I have mentioned.

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Preoccupations of much the same kind are evident, incidentally, in the European Economic Community's medium-term economic programme, which member nations have accepted as a guideline. In it, there is explicit reference to imbalances connected with the pressures of public expenditure and expanding consumption, and a warning that without corrective fiscal, monetary and wages policies these pressures may compromise the Community's projected overall growth rate.

The Problems and Responsibilities of an Open Economy.— Ten years have now passed since the creation of the European Economic Community and since the first satellites were launched into space. It is surely not without significance that an achievement which made it plain how far Western Europe lagged behind the great powers in technology should have coincided with the inauguration of a unifying effort by which alone Europe can hope to keep alive its contribution to world progress.

When the European countries had to build up their economies again after the destruction of the last war, they did so partly in the spirit of the traditional principles of European civilization, principles which after their eclipse in the interwar period had come to the fore again and the adoption of which, moreover, was being recommended from abroad, as, for example, the freeing of trade and payments, and partly, by the force of inertia, along lines reflecting the ideas of the thirties.

The one great new departure, which was destined to call forth profound transformations, was the grand design of the unification of Europe, even though eventually it was put into effect on a more limited scale than had originally been intended. Formidable obstacles have had to be overcome so far, and assuredly the future will demand of us a responsible joint effort of all economic and social forces.

Our economy's reaction—spontaneous rather than organized—to the great opportunity of joining the European Common Market and, more generally, to the challenge of international competition has gained us many a prize of incontestable value. Between 1958, when the Treaty of Rome came into force, and 1966 our gross national product rose by more than half, at an annual rate which is among the highest in Western countries. More than a million jobs were created outside farming during the same period. Our export trade more than doubled, an achievement which far outstrips that of any other developed country except Japan. Our share in the world's trade in manufactures rose from 4 to 7 per cent, and the ratio of Italian to international export prices decreased at an annual average rate of 1.3 per cent, as a result of the former falling by 0.4 and the latter rising by 0.9 per cent. I recall this record of past performance as a good omen for the future.

Forthcoming developments within the Common Market and its opening up in relation to the rest of the world raise certain problems of adjustment. In the face of these problems, the overriding task before us must surely be to do our utmost to raise productivity, in the economically backward areas no less than in the advanced ones. The approaching target dates leave little margins for delay in taking indispensable measures, and none at all for mistakes, such as the artificial creation of, or the overlapping of, production lines, which are doomed to failure in an integrated economy, with a resulting waste of real and financial resources. Whatever solution is adopted, it must be guided by our need to improve the mechanism by which the nation's resources are put to the most productive use, in the knowledge that this is the only way in which a durable contribution can be made to the necessary development of our country's economically less advanced areas.

There is a major task awaiting to be done, therefore, in co-ordinating the required transformations in line with programmes conceived on the national and regional scale. The tangle of legislative provisions and the organizational framework must never be allowed to weaken the all-important impulse to go ahead and do things; nor must we ever lose sight of the fact that if our economy is to assume a more industrial character, it must do so in the setting of an open market, which means that its industries must be highly competitive. In this connection a warning must be given that the maintenance of competitive export prices hides cost increases which make inroads into the earning capacity of firms.

What has been said in previous Reports remains as true as ever. The financial structure of firms in our country is at present less strong than it was in previous years, when it enabled us to secure a growing share of world trade.

If we compare the capital structure of a group of the largest manufacturing companies in the European Economic Community, we see that the burden of debt lies heaviest on Italian companies.

Over the three years 1963-1965, total debts corresponded to 57 per cent of assets in the case of the Italian companies, compared with 32 per cent in the Benelux countries, 39 per cent in Germany and 53 per cent in France. The ratio of the firms' own capital and reserves, including staff retirement funds, to fixed assets was 1.7 in the Benelux countries, 1.4 in France and Germany, and 1.2 in Italy.

The flows of savings between the different sectors of our economy, as shown in our Annual Report, deserve careful consideration. Total formation of financial assets in the economy, including bank notes, deposits, securities and other credits, amounted to 3,650 billion lire in 1961; in 1966 the figure was 6,500 billion lire, and of these 4,400 billion accrued to households. Magnitudes of this order impose a heavy responsibility on all of us to make sure that the wealth they measure is adequately employed to yield immediate or later returns.

Another figure I want to draw attention to is the high proportion of savings absorbed by the public administration (2,115 billion lire in 1966), though in pointing this out I do not want to join in the doubts it has become customary to express about the ability of the public administration to make productive use of the resources entrusted to it. Be that as it may, the figures of our Report make it clear that even some of the resources accruing to firms are so invested that they do not allow adequate depreciation and remuneration of capital.

The new tariff reductions agreed at the conclusion of the Kennedy Round, which are more far-reaching than any that preceded them, place our economic system more, and more directly, in contact with the technologically most advanced countries of the world and force us to look for new industrial applications. Our economy must not draw its impulses exclusively from demand for traditional products; we cannot forgo the more ambitious aim of joining the big concerns which are now being formed on European scale with a view to pioneering the development of new products.

When all is said and done, the way to raise *per capita* incomes in Italy closer to the level of those elsewhere in the European Community is to increase the amount of capital investment per person employed and to accept the restrictions this implies in terms of the volume and composition of public expenditure, and in terms of taxation and of income distribution.

The aim of the analyses contained in our Report has been to increase awareness of the forces which are transforming our society. Objective necessity imposes upon us certain adaptations, without which our productive forces would be prevented from giving of their best.

The very range and speed of the changes we have witnessed in recent times and must expect in the future make the task of interpretation harder, because there is always a danger that one may be talking of situations already overtaken by events, even in looking into the future. This is all the more reason why the dialogue between the groups that contribute to production is more needful than it has ever been before in our country, why it should be carried to yet higher levels and should become yet more active and frank. Let the new generations have their say, too, and let each group bring to this dialogue not only its own contribution of knowledge, but a determination to temper its sectional claims for the sake of the common weal.

XII. *The Bank's Capital, Reserves and Profit*

No change occurred last year in the composition of the Bank's shareholders and, hence, voting rights. Under the Bank's Statute, every shareholder has one vote for every 100 of the first 500 shares and for every 500 additional shares, provided that they have been owned for not less than three months. On 31 December 1966, 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 6,871.3 million lire on 31 December 1965, rose during the year to 7,664.8 million. This was the result of appropriations of 155.1 million from 1965 profits and of 708.7 million investment income from the reserve fund itself, and a diminution of 70.4 million, which represents distribution to shareholders of part of the 1965 investment income from the fund (under Article 56 of the Statute).

Extraordinary Reserves rose from 3,569.5 million lire on 31 December 1965 to 4,661.3 million at the of 1966. This was the result of appropriations of 155.1 million from 1965 profits and of 974.3 million investment income from the reserve fund itself, and a diminution of 37.6 million, representing distribution to shareholders of part of the 1965 investment income (under Article 56 of the Statute).

Profits, as shown by the Profit and Loss Account for 1966, were as follows:

Gross receipts	Lit.	133,525,316,777
Expenses and losses written off	»	132,685,232,996
Net profit . . .	Lit.	840,083,781

THE GOVERNOR
GUIDO CARLI