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PRESENTED BY THE GOVERNOR TO THE

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HELD IN ROME ON 30 MAY, 1970

Excerpts from the Governor's Concluding Remarks

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III. – Excerpts from the Governor's Concluding Remarks

The spread of inflation, international liquidity and the foreign exchange system

The outstanding features of economic developments in the main industrial countries in 1969 can be identified in the spread of inflationary pressures, the preponderant recourse to monetary policy and the resultant rise in interest rates, and the intensification of transfers of short-term funds. At the centre of the picture is the decision of the United States authorities to regulate overall demand by the adjustment of the money supply, a step dictated by the need to exert a more direct influence on the level of demand.

According to the Federal Reserve and the President's economic advisers, the price increases in the United States, their spread to other countries and the deterioration of the current account of the balance of payments are supposed to be manifestations of a process of inflation fostered by a large Government budget deficit in a situation close to full employment of the economy's resources. The rise in interest rates, they contend, is due to a large expansion in the demand for funds not matched by an adequate growth in supply, owing to a tendentially restrictive monetary policy.

This interpretation is opposed by another according to which both these phenomena are due to a monetary policy which is in fact expansionary. The cause of the inflationary tensions lies, according to this interpretation, not in public expenditure as such but in the ways in which it has been financed, namely by an excessive creation of money. This, it is said, has set in motion the process consisting of expectations of increasing price rises and a growing propensity of lenders to ask and borrowers to accept higher nominal interest rates. In short, this second interpretation places the expansionary monetary policy, and not its opposite, at the origin of the high rates.

In the present state of our knowledge it seems beyond doubt that the increased public expenditure unaccompanied by additional taxation is the cause of the inflationary tensions in the United States. The Federal Government budget deficit shows an increasing deterioration from 1965 until the second half of 1968, when the Government introduced the temporary surtax of 10 per cent on the profits of corporations and on private incomes and imposed ceilings on the expansion of the main categories of expenditure. The inflationary potential inherent in the growth of public expenditure was increased by the nature of the expenditure, the highest annual rate of increase being in the components connected with the military sector. The rise in prices had certain redistributive effects in favour of firms and created expectations of their continuance. There was a further increase in overall demand, in monetary incomes and in the volume of money required for transactions, leading to pressures on interest rates.

The restrictive fiscal and monetary policy adopted towards the end of 1968 affected the course of the American economy during 1969, a year of slackening expansion according to the Federal Reserve, in which unutilised productive capacity and the rate of unemployment increased appreciably, industrial output underwent a sharp reversal of trend, the rise in costs was accentuated and corporation profits contracted, while the rate of increase in prices did not slow down. Nevertheless, fixed capital investment by the manufacturing sector continued to expand at a growing annual rate. This is probably attributable to the belief that the restrictive monetary policy was of a temporary nature. Under these conditions it seems safe to say that the most showing result achieved by the restrictive policy in 1969 manifested itself at the international level: the high interest rates ruling in the United States helped to bring about a shift of liquid dollar funds held by non-residents, promoting their transfer from official authorities to private sector, a process which was reflected in an improvement in the United States' balance of payments on official transactions basis.

Assuming that the monetary base was the strategic variable through which the money supply was regulated, it would have been more logical to accept the assumption that the whole range of interest rates would undergo the variations due to such an action. Instead, limits were maintained on the interest rates on deposits and certificates of deposits and, at the same time, the public's access to the Treasury Bill market was restricted by a raising of the minimum denomination of newly issued bills· The widening of the gap between the free rates and the regulated rates led to a reduction in deposits and impelled the banking system to safeguard its own share of the market, threatened by the yields of financial assets offered by intermediaries not subject to regulated rates. The increases in long-term interest rates and the rates paid on the deposits of branches abroad were in fact accentuated by the official fixing of the rates on time deposits of residents and the following reduction in deposits of this category. The banks' reaction was on the one hand to sell substantial quantities of bonds, thus aggravating the fall in prices, and on the other hand to attract deposits via their foreign branches by offering exceptionally high rates, which consequently spread to the markets of the various countries concerned.

The American authorities have found that the deviations brought about by the constraints on rates lengthen the periods of time required to enable monetary policy to produce results and diminish its effectiveness; the unusual scale of the deviations showed that these constraints bring about movements contrary to the aims pursued by the control of credit expansion. Last January the monetary authorities therefore decided to fix the maximum rates on time deposits and certificates of deposits close to the free rates; but there remained the burdensome legacy of the new markets, which, by their very existence, increased the system's ability to resist the effects of monetary policy.

In June 1969 the monetary authorities had adopted measures concerning the constitution of obligatory reserves, as a counterpart to the changes in deposits received by American banks through their foreign branches. These measures had two aims: on the one hand, to discourage further obtaining of deposits on the Euro-dollar market, with a view to helping to reduce the pressures on interest rates, and, on the other hand, to prevent too large a reflux of liquid funds from the Euro-dollar market into the reserves of central banks, in order to soften the impact to which the international monetary system would have been subjected when the conditions offered by American banks had reduced the attractiveness to non-residents of keeping their available liquid funds with these banks.

At the beginning of 1970, United States monetary policy became less restrictive, probably because of a belief that an accentuation of the signs of economic recession would have provoked the reaction of the country's political leadership and that the latter might have adopted expansionary policies which would have produced inflationary forces even more serious than those which the monetary authorities were trying to curb. At the same time the pressures on costs and the expectations that they will become worse have been intensified, on the eve of the outbreak of trade union disputes in some sectors of industry. The monetary authorities must therefore decide how much to expand the money supply and allow the cost increases to be passed on to prices. Actually, business expectations are now being revised. This revision, necessitated by rapid deterioration in profits, financing difficulties and slowing down of some components of demand, could lead to a curtailment of investment programmes and ultimately to a contraction in productive activity and employment on a scale harmful to the United States and the rest of the world. Since, with such prospects, the need for domestic economic revival would prevail on requirements connected with external equilibrium and, on the other hand, stable monetary conditions at high levels of output and employment could coexist, as has already occurred in the past, with a balance of payments deficit, dollars might continue to be in abundant supply, accentuating the disadvantages of a system based on fixed exchange rates.

The worsened prospects are reflected in the fall in prices of shares of United States corporations in recent weeks. The downward trend of prices began in the last months of 1968, almost simultaneously with the introduction of the monetary restriction, during which yields on fixed-interest securities rose to unprecedented levels. The persistence and extent of the decline influenced the movement of share prices in the other industrial countries, owing to the growing number of channels of communication between security markets.

In the United Kingdom, undeniable success was achieved by fiscal and also monetary policy in keeping in check the various components of domestic demand and thus reversing the country's external position; in view of these developments, the monetary authorities were able, this year, to lower the discount rate twice, the second time as part of the measures designed to produce a cautious revival of domestic demand. The future trend may, however, be strongly affected by the movement of labour costs, the recent behaviour of which seems to be renewing inflationary pressures.

In France, after the devaluation of last August, which took place while a marked inflationary process was still in progress, the authorities introduced an intensive programme of fiscal and monetary restriction, which is proving particularly effective in curbing domestic demand, so that there seem to be good prospects of a slowing down of the rise in prices, which are also subject to direct controls.

In Germany the mark was revalued after the expansion in domestic demand and the strains of the labour market had brought about an upward movement of prices which is still accelerating. While the measure had the effect of restoring equilibrium in foreign relations, its contribution to moderating the domestic boom will depend on the success of the action taken to curb demand, hitherto centred mainly on changes in the discount rate, which has been increased several times since April 1969, when it stood at 3 per cent, until March of this year, when it reached 7.5 per cent.

The differing degrees of expansion of demand within the individual countries and the resultant divergences in price trends produced balance of payments disequilibria which in some cases were corrected and in others aggravated by capital movements brought about by interest rate differentials and by expectations of changes in monetary parities and political and social anxieties. During the two-year period 1968-1969 the maximum change in the net foreign creditor position of the monetary institutions was 5.1 billion dollars in France, 6.2 in Germany and 1.5 in Italy. The same change for the European Economic Community was 8.9 billion.

It is thus confirmed that the increased interdependence of the Western economies, in the absence of any coordination of economic policies, requires that the international monetary system should possess a certain degree of flexibility, either with regard to the multilateral and bilateral credits on which it can rely or with regard to the exchange rates between the various currencies, or both of these.

The discussions concerning the reform of the international monetary system which were started in 1963 led to the decision to create special drawing rights totalling 9.5 billion dollars over the three-year period 1970-1972, of which 3.5 billion have been distributed this year. The Amendment to the IMF Articles of Agreement contains ideas put forward by the Bank of Italy: the reform of the system, the Bank contended, would have to be such as to enable the volume of international liquidity to be adjusted to the requirements for financing the balance of payments the scale of which is greater the larger the increase in the volume of trade and capital movements; the volume of international liquidity would have to be determined by decisions of international institutions independently of the supply of newly-mined gold; and the system would have to be based on the acceptance of fixed rates of exchange.

The Bank of Italy upheld these views in the conviction that acceptance of fixed exchange rates would help to speed up the process of economic integration and that the latter, if carried out within the framework of institutions such as the European Economic Community, would have accelerated the process of political unification. Last year's Report referred to an adaptation to changed conditions and a certain preference was expressed for systems that included moderately flexible exchange rates. Recent events lead us to confirm this preference and to consider as a progress the discussions initiated within the international institutions on reforms that do not rule out acceptance of a certain degree of flexibility in the exchange rates between the various currencies, duly limited by international agreements so as to restrict the margin of uncertainty. This course would create the conditions for greater monetary independence vis-à-vis external factors, and especially in relation to the U.S. dollar, without destroying the link between the markets, which has allowed in the past, and will allow in the future, a steady growth of trade, which, in turn, is one of the prerequisites for improving the standard of living in Western countries.

At the beginning of the 1960s Italy shared the hopes, expressed by authoritative international bodies, that economic planning would be centred on incomes policy, which was interpreted as the responsible participation of trade unions in the taking of decisions concerning the production of income, its utilisation and distribution. It should be admitted that in Italy, as in other countries, it has not been possible to coordinate the trade unions' demands with the other variables which determine economic equilibrium; everywhere the result has been cost tensions of varying intensity. Nor is there any prospect of a reduction in the variability of wage increases in relation to productivity in the various countries. Furthermore, the differing degree of elasticity of import demand in relation to income, in a period in which the latter is increasing rapidly, will also tend to increase the complexity of the process of adjustment. The balance of payments disequilibria may in turn be aggravated, because there is very widespread anxiety among businessmen concerning domestic and international political stability, and political factors make it difficult to determine the direction of capital movements.

Although the modern world, partly as a result of its very dynamism, is particularly prone to inflationary pressures, the intensity of such pressures will probably continue to vary, so that it will be difficult to reconcile a greater degree of economic interdependence with a system of fixed exchange rates; hence it may be necessary to resort to a limited flexibility. Such an innovation might stimulate the transformation of the European Economic Community into an economic union, if the currencies of the member countries were to become interchangeable among themselves on the basis of fixed rates, while being convertible into non-EEC currencies at fluctuating rates. This would presuppose some progress towards the unification of economic and monetary policies. But should this progress be made by coordinating and harmonising the various policies, or by first of all unifying the institutional structures within which such policies are carried out? I tend to favour the second solution. I believe priority should be given to the unification of the institutions; I believe less in the possibilities of coordination. The process of bringing economies closer together by stages has probably exhausted its driving force.

Some people suggest that the central banks should immediately pool part of their reserves so as to promote the coordination of economic policies. These suggestions are based on the idea that central banks, as they are largely autonomous bodies, would be better fitted for laying down long-term policies and would be capable of influencing Government decisions. Without even considering the soundness of the idea underlying this argument, however, it seems doubtful whether a community institution could fulfil the function which it is proposed to assign to it; it would probably be exposed to conflicting political pressures more than the individual central banks are at present and the effect would be exactly the opposite of what was intended.

When the European Economic Community was founded, it was thought that greater economic prosperity would ease social tensions. Actually, they became more acute—on the one hand because the high standard of living obtained itself made individuals aware of the possibility of aiming even higher; and on the other hand because backward social conditions, which, for various reasons, exist almost everywhere, have become less and less tolerable.

These growing tensions call for an effort of adaptation in the institutional field at both the domestic and the international level.

It must be admitted, however, that the existing institutions, although imperfect, have allowed the high degree of cooperation between the Western economies to remain unimpaired. Italy has made an active contribution to international cooperation and, even in view of recent events, has no reason to regret it; some of the country's difficulties have been mitigated thanks to this cooperation. The difficulties have been due to certain developments, some new and some merely aggravated, in our economic situation, both in its internal productive and monetary aspects and in its financial relationship with other countries. Let us now turn our attention to these developments.

The repercussions of capital movements on Italy's balance of payments

After five years of surpluses, Italy's balance of payments closed with a considerable deficit in 1969 owing to the intensification of net capital exports. The deficit became exceptionally large in the first two months of 1970, but contracted appreciably in the following two months owing to the less unfavourable trend of the current account but, most of all, of capital movements. To finance this deficit recourse was had to the reciprocal swap arrangement with the Federal Reserve Bank of New York. This action was based on two considerations:

— as has been pointed out in the past, reserve assets are invested with an eye to combining liquidity and yield; however, considerable balance of payments deficits—attributable either to unforeseeable fluctuations in the current account balance due to interruptions in production or to capital movements—may give rise to requirements that cannot conveniently be met by disinvestment;

— as the magnitude and the timing of the correction of the deficit are difficult to foresee, it may be advisable to finance it by utilising short-term credits; in Italy's case, when recourse was had to such credits, talks had been started concerning medium-term financing operations, the result of which was impossible to forecast.

With regard to capital exports and their effects on the process of financing domestic investment, justifiable concern has been expressed and inaccurate statements made. Of the resources formed as a result of the high levels of production achieved in Italy, part, representing the surplus on the balance of payments current account, was invested abroad. The ensuing increase in the country's assets took the form of export financing, private financial assets and foreign exchange reserves. The persistence of a surplus on current account during the period 1965-1969, equal to 3.2 per cent of the gross national product, indicated the Italian economy's inability to turn a large proportion of the savings formed within it into domestic investment. In the body of this Report and in these Concluding Remarks, mention is made of the causes which impeded domestic investment: the failure of the public authorities to adjust their structure to the complex functions which they have to perform; the lack of appropriate financial instruments; the high level of business indebtedness; and the uncertainties as to future prospects. Within this framework, the monetary policy pursued during this period was aimed at making good the loss of liquidity due to capital exports. It was not until the summer of 1969 that the strengthening of inflationary pressures, together with the losses of reserves, forced the authorities to pursue a less expansionary policy, with unfavourable effects on the cost of financing.

The phenomenon of private capital exports, which is generally identified with that part of it which consists of the illegal export of bank-notes, is in fact more complex. The anxiety felt about the consequences of this phenomenon are not without foundation and the monetary authorities consider it their duty to suppress its illegal manifestations, without, however, risking to do disastrous damage to the freer trade and payments system which, not without difficulty, has been attained.

The discontinuation of the repurchase of bank-notes by the Bank of Italy, the adoption of a tax on reimported notes and the creation of the so-called financial lira are solutions that amount to the reintroduction of foreign exchange control. Some people are asking for foreign exchange control to be re-established in a situation of progressive international integration in which the size of the domestic market is clearly inadequate to meet the requirements of consumers and producers, as is shown by their increasing recourse to foreign products, foreign markets, advanced technologies wherever they are to be found and, in general, to an evergrowing international component, both in the organisation of production and in consumer expenditure. This component is also finding its way into choice of portfolio investment, and may have helped to accelerate the export of capital for the purpose of achieving the desired diversification—all the more so because this diversification has been impeded by the policy pursued within the country, which has accentuated the undifferentiated nature of our capital market.

All the solutions suggested have been considered by us, including that of asking foreign banks, and especially those in Switzerland, to give us their lists of Italian depositors. We refrained from making this request because we believed that it would be refused, as have been similar requests made by countries with greater bargaining power than we had. The Bank of Italy's refusal to repurchase reimported bank-notes leads to their allocation on the foreign market at an exchange rate lower than the official rate, in order to meet demand from tourists and emigrants. Similar results are produced by a tax on reimported bank-notes. Nor would the introduction of the financial lira be a new solution; it has been found in practice that it is effective insofar as the divergences in prices between the official market and the capital market are restricted by intervention by the authorities and thus, ultimately, by sales of foreign exchange taken from the reserves. Lastly, the solutions in question tend to lose their effectiveness quickly unless they are reinforced by the multiplication of controls, which in turn produce increasing distortions.

The Bank of Italy preferred to confine its intervention to the measure taken last February whereby Italian bank-notes returning from abroad are collected centrally at the Bank of Italy, thus lengthening the time between their being dispatched and their being credited on capital account. In the period March-May 1969 bank-notes totalling 336 billion lire were repurchased; in the corresponding period of 1970 the total was reduced to about 150 billion lire; the percentage difference between the price for bank-notes and the official rate was kept between 1 and 2.5 per cent. The Bank also restricted the length of time within which importers and exporters, respectively, could advance payment for goods and defer collection of payments, the aim of this being to limit the export of short-term capital connected with goods transactions and stimulated by the interest-rate differential between the domestic and international markets. Lastly, in a situation in which the differential tended to decrease or even to be reversed—that is, when credit abroad became cheaper than in Italy—the Bank of Italy allowed banks to refrain from complying with the obligation to balance their foreign exchange position and make use of foreign credits to finance Italian exports, the purpose of this step being to place Italian exporters on an equal footing with their foreign competitors.

The Bank of Italy is still convinced that any autarkic policy has regressive effects on the evolution of income and we hope that this conviction will continue to inspire the country's economic and financial policy. Compulsory measures are limited in their effectiveness and in any case restricted in terms of time. Hybrid systems do not last and sooner or later lead to autarky. External payments equilibrium must be sought by creating conditions of yield and taxation for domestic investment which are competitive with the alternative opportunities offered abroad, and a general situation that favours the investment of foreign capital to outweigh the outflow.

This is the direction in which we have acted during the recent period and it is satisfying to note that Italy continues to be a country in which foreign private financial institutions are prepared to invest very large amounts of capital; we refer to the loan operations already concluded and those which are likely to be so in the near future. We are reaping the benefit of a persevering policy of financial cooperation tenaciously pursued at all levels: it is gratifying to recall the readiness with which the United States Treasury and the Federal Reserve Bank of New York, in the brief space of one day, increased their credit lines to the Bank of Italy by 500 million dollars, and the readiness with which American, Canadian, British, German and other banks participated in the conclusion of the major loan operation to which we have referred.

The total of the loan operations completed and approaching completion amounts to about one billion dollars. Most of them have been negotiated on the basis of an interest rate which is variable from half-year to half-year in relation to that applicable to inter-bank dollar funds on the London market and they give the borrower the option of premature redemption without payment of any penalty. It seemed to us desirable to include this clause in order to give ourselves the possibility of paying off the loans as soon as our balance of payments conditions permit or, possibly, of replacing loans at high interest rates with others on less burdensome terms.

We arranged that the borrowers should temporarily pay the countervalue in dollars into accounts at the Bank of Italy in order to eliminate the expansionary effect on domestic liquidity and relieve the borrowers of the need to maintain lira holdings in excess of their immediate needs. During the period in which these sums remain on deposit at the Bank of Italy, the procedure is tantamount to the imposition of an obligatory reserve of 100 per cent. The proceeds of these loans were used by the Bank to repay short-term debts contracted in the first two months of the year. We have thus consolidated our indebtedness and correspondingly increased our net official reserves. The increase in May was about 400 million dollars.

Wages, costs, prices and the equilibrium of enterprises

The recent wage increases, coming on top of the rises in prices of imported raw materials, confront the monetary authorities with complex problems from the dual angle of curbing inflation and safeguarding the economic equilibrium of enterprises as prerequisites of growth.

It is necessary to undertake a quantitative assessment making adequate allowance for foreseeable increases in the cost of labour per unit of output; it is necessary to establish to what extent it is possible to transfer the cost increases to prices and what are the results of the contraction in expected profits as regards capital investment decisions, and in current profits for financing purposes; lastly, it is necessary to estimate the propagation effects of the price increases in the various sectors. For this purpose a distinction must be made between the sector comprising the activities most exposed to foreign competition and that comprising the activities which are relatively free from such competition, since the possibility of enterprises to adjust their prices to the requirement of covering costs, plus an appropriate profit margin, is less or greater depending on whether they belong to the former or the latter category.

When direct costs go up owing to rises in the cost of raw materials or the cost of labour or to a combination of both these causes, enterprises tend to transfer the increases to consumers; but the greater or lesser extent and rapidity of such transfer depends on the greater or lesser strength of demand in relation to the higher or lower degree of utilisation of productive capacity.

The empirical studies made show the irregularity of the evolution of productivity, which rises faster at the beginning of the expansionary phase of the business cycle and slows down as its peak is approached. This trend appears to be attributable to the lack of homogeneity of the factors of production, as a result of which, as demand expands and the degree of utilisation of productive capacity increases, use is made of progressively less efficient equipment and labour, leading to declining returns per unit employed. The rate of increase in productivity actually falls when the system, under the pressure of inflationary processes, is most in need of higher productivity. Under these conditions the rate of monetary expansion represents an instrument for curging demand and, ultimately, profits. Recourse to it may become even more necessary when the shortening of working hours restricts the possibilities of utilisation of invested capital and thus the possibilities of expanding supply. But the monetary instrument is undoubtedly imperfect owing to its insufficiently selective nature and owing to the difficulty, in the short term, of controlling the volume of credit, which also depends on the behaviour of businessmen, by regulation of the monetary base.

Whereas, in the sectors less exposed to international competition, increases in labour costs are accompanied by large positive changes both in prices and in unit profits, in the sectors which are open to competition, domestic prices display greater sensitivity to variations in prices of foreign products. If the latter are stable, increases in the cost of labour per unit of output bring about, in the short term, reductions in the quota of other incomes, which, owing to the interdependence between sectors, are adversely affected also by rises in labour costs in other less exposed activities. An increase in the prices of competing foreign products makes possible, on the other hand, an increase in profits and offsets the negative effect of the higher labour costs on unit profits. The rises in productivity in the sectors exposed to international competition are greater than the average rises throughout the system; this difference is probably largely attributable to technological reasons, but the positive effect of foreign competition cannot be ruled out.

Under a system of free trade and fixed exchange rates, the last barrier which prevents a further transfer of cost increases to prices consists of international prices. When this barrier has been reached, increased expenditure is directed towards imported goods. A rejection effect takes place via the balance of payments, which moves from equilibrium to deficit or from surplus to a smaller surplus. In these circumstances, growing monetary demand can coexist with stationary domestic production and employment. The proposition that the economy should be given as much liquidity as it needs is tantamount to saying: do not give any liquidity which feeds a balance of payments deficit.

In the course of the controversies concerning the interpretation of the relationships between prices and cost increases brought about by wage increases, it is often asserted that the present price rises are due to structural deficiencies in our economy. These do admittedly play a part in restricting the possibilities of supply, especially in housing, public transport, public health services, etc. Our Reports have for a long time emphasized the harmful effects of inadequate investment in the social infrastructure. It has been repeatedly stated that this inadequacy would be reflected, sooner or later, in cost and price increases. But it is not wise to expand monetary demand while disregarding the possibility of bringing supply into line with it, as if to emphasize past mistakes; for the short-term effect will not be to improve supply but only to curtail the purchasing power won through the labour conflicts.

The problem of the relationship between the rate of inflation and structural deficiencies is bound up with observance of the conditions for monetary stability; for the latter to be maintained it is necessary that the increase in monetary demand due to wage increases should be coupled with a corresponding growth in the real flow of resources. This correspondence can also be achieved as the structural deficiencies are remedied, but inevitably at a slower pace than for short term variations in economic conditions.

In most cases, however, the adaptation of the social infrastructure has not run up against any financial limits, nor, certainly, have such restrictions hampered the building of workers' dwellings; the limitations have been and are of a different nature and their removal calls for unremitting effort by the public authorities, an arduous task which cannot be implemented merely by public opinion. If there is an inadequate supply of social services, it may be decided to impose administrative restrictions on prices; but it is essential to realise the inherent contradiction in policies which expand purchasing power when they give rise, sooner or later, to the need to introduce price controls in order to defend the purchasing power which has been so liberally distributed. The defence may furthermore prove to be illusory if the excess demand is concentrated in the sectors where the controlled price list does not apply: the ultimate result may be even larger price rises or increased imports, or both these phenomena.

Inflationary impulses from abroad will continue in 1970 to be one of the factors pushing up domestic prices, but they will be greatly aggravated by wage increases. According to estimates made at the end of last year by the Technical Committee of the Ministry for the Budget, the average increase in the cost of labour per worker in the economy as a whole in 1970 is likely to be 13 per cent. More recent data from another source point to an even larger average increase of about 16-17 per cent.

In the industrial sector, which is more affected than the others by the wage claims, the rises are expected to be higher; according to the estimates of the above-mentioned Committee, the increase in industrial earnings in 1970 is likely to be between a minimum of 11 per cent in the sector for which no renewals of contracts are scheduled and a maximum of 21 per cent in the other sectors; in the latter, according to other estimates, the increases will be very much greater.

The differences in wage movements are, however, merely temporary and tend to disappear as the wage contracts in other sectors expire, as is shown by the textile sector, where workers have obtained an increase similar to that in the engineering sector.

With further contracts expiring during the year, three quarters of all industrial workers will have received wage rises representing practically uniform rates of increases by the end of 1970. This uniformity is in contrast in the various sectors to the very wide range of changes in productivity; for instance, with regard to the industries whose contracts have already been renewed, there is a great difference between the metallurgical and chemical industries, on the one hand, and the engineering and textile industries, on the other. In the case of the former, both very capital-intensive industries, with relatively newly-constituted and therefore technologically advanced plants, the productivity increases are high; in the case of the latter, conditions are much less favourable, factors contributing to this being the existence of firms which differ greatly in efficiency and size and also the limited impetus imparted by scientific research and technical innovations. For the engineering industries, furthermore, the situation is made more serious by the fact that the prices of their raw materials rose particularly sharply during the year.

In any case, the rate of wage increases in general has been more than double compared to the productivity gains possible in the most rapidly advancing sectors. Consequently the wage rises are bound to be reflected, to a greater or lesser degree, in higher labour costs per unit of output, and although their extent will differ from sector to sector they will be sufficient to create serious difficulties for the maintenance of financial balance by enterprises, even assuming that they are partly transferred to prices.

Still according to the above-mentioned document produced by the Ministry for the Budget, the maximum limit beyond which industrial prices should not be allowed to increase is 6 per cent. This limit is seen to have already been exceeded in view of the difference of 6.5 per cent between the level reached in March 1970 and the average for 1969, while compared with the figure for a year earlier it works out at nearly 9 per cent, so that the rate of increase in prices in Italy, which had up to last year been below that in other Western countries, is now greater than that in most of them.

The difficulties experienced by small and medium-sized firms —on which the impact of prime cost is generally stronger—are sapping their capacity to survive, so that they are tending to seek protection from big companies, even abroad, or from public enterprises.

Many foreign enterprises are acquiring participations in Italian firms, thus in a number of cases weakening their autonomous and promising growth potential. In other cases, Italian firms are taken over by others in the public sector of the economy. Often the price is paid to the foreign holding companies in whose nome all or part of the shares in the enterprises taken over had been registered. The concentration of means of production in the public sector sometimes leads to a technical improvement in the enterprises, but in other cases to a restriction of the area of competition or to the forced rescuing of inefficient firms, both of which developments are harmful to the proper working of the mixed economy.

The promise of credit facilities in order to halt these processes does not help, because there are limits not only to credit-granting possibilities but also to the firm's capacity for taking up credit. It is therefore necessary to examine the mechanism of business financing.

In the last twenty years enterprises have financed their investment by increasing their recourse to borrowing; this, in turn, has taken the form of indebtedness to financial intermediaries. The effect of this process has been an increase in the financial intermediaries' raising of funds through the creation of liquid or quasi-liquid credit instruments. In the five years 1951-1955 loans to the economy through the direct issue of credit instruments represented 13.8 per cent of overall financing; this ratio decreased to 11.3 per cent in the period 1956-1962 and to 8.2 per cent in the period 1963-1969. In the same periods the public's liquid assets rose by annual averages of 14.4 per cent, 13.2 per cent and 12.4 per cent, while the rates of increase in the gross national product at current prices were 10.2, 8.9 and 9.5 per cent.

The method mainly used by enterprises to meet their long-term financial requirements was to borrow from the special credit institutions, often at rates subsidised by the Government. The special credit institutions, for their part, obtained the funds by issuing bonds, which were largely subscribed by the banks. This financial circuit and the preferences of savers, together with the reduced share of direct financing, led to the formation of large balances of money and quasi-money mostly in the form of bank deposits.

The separation of the centres of savings formation from those making the investments became gradually more pronounced; in 1969 the share of net household savings in relation to total savings rose to 80 per cent. This not only proves that the process of financing depends on the continuity of household saving but also indicates the complexity of the financial intermediaries' task of supplying both the public authorities and business with the funds they require for their activities.

The harmful repercussions are most noticeable in private enterprises, which, owing to their present financial situation, seem to have little inclination to compensate for the shortage of risk capital by further borrowing. Public enterprises are less sensitive to the burden of indebtedness, since they are less hard-pressed both by the requirements of business liquidity and by those of the rate of return on risk capital. The Report shows that in the past six years there has been approximate equality between public and private enterprises in the rate of gross saving; the former, however, have made bigger increases in their fixed technical assets, so that their rate of self-financing is lower than that of private enterprises. In industry, fixed investment undertaken by public enterprises in 1969 represented 38 per cent of the sector's total investment.

Interest rates, inter-bank competition and organisation of the capital and money markets

The wide fluctuations in interest rates have revived discussion concerning the relationships between prices, interest rates and monetary policy. Without embarking on theoretical arguments, we think that it can be said that in the presence of inflationary expectations nominal rates reflect these expectations, generally with a time-lag, and tend towards the maintenance of a relatively stable level of real returns, which, furthermore, under the pressure of increasing economic interdependence, tend to assume fairly uniform values in the markets of all developed countries.

History shows that changes in prices are usually coupled with changes in interest rates in the same direction; this has been observed, for instance, in the United States and the United Kingdom over the decades. This relationship was suddenly disruped at the time of the second world war; in both the United States and the United Kingdom, during the war and the immediate postwar period, the expansion of the public debt was accompanied by stability of interest rates, achieved by policies of rapid expansion of the money volume coupled with compulsory curbing of private expenditure. At the beginning of the 1950s interest rates in both countries were at abnormally low levels. It was in this situation that their rise began. The increase was gradual, although in the United Kingdom the maintenance of external equilibrium necessitated a structure of interest rates higher than that ruling in the United States. In more recent years, inflationary expectations have played an important part in bringing about the rise in nominal rates.

In both the United States and the United Kingdom, 1969 was the year in which there was an accentuation of monetary policies mainly based on control of the quantity of money. While those interest rates which were free to move reached very high levels, those which were held down by administrative regulations created greater tensions in the market areas where freedom prevails. It would appear that the peaks have been reached, but it is also probable that the failure to control inflationary pressures and expectations of their continuance will keep interest rates at high levels in the immediate future.

This picture of extreme tension in international interest rates and growing difficulties in controlling capital flows forms the background to the decisions taken by the Italian monetary authorities in the first half of 1969, which became operative in the second half of the year. These measures were inspired not only by the need to help to reduce the pressures leading to capital exports by promoting the alignment of domestic interest rates with international rates, but more particularly by the conviction that the inflationary pressures from abroad which appeared in the Italian market in the first half of 1969 would be supplemented by other impulses — the full force of which was not known when the decisions were being made— deriving from the settlement of labour disputes affecting a large number of dependent workers.

The manner in which the increase in interest rates took place in Italy will be discussed a little further on; with regard to the choice of timing, it should be emphasized that this made it possible, within a period of about six months, for Italian interest rates to be brought to a level close to the highest prevailing abroad.

As interest rates in Italy had approached the peak at the time when in the major markets, despite some contrast, a downward trend was becoming apparent, the problem arose whether this movement ought to be followed or if, on the other hand, it was and is advisable to aim at a relationship between Italian and foreign interest rates corresponding to the need to attract capital to Italy. The progress of integration within the European Economic Community, the possible enlargement of the Community and a policy of increasing participation to international markets, together with the acceleration of the adjustment of Italian wage levels to Community levels, theoretically give Italy the position of a net capital-importing country, at least as long as there is a gap between the amount of capital available per person employed in Italy and that in the other industrial countries of Europe.

In order to interpret the policy pursued with regard to interest rates it is necessary to mention the distinctive features of the Italian market, from the point of view both of the responsiveness of rates to changes in the monetary base and of the interdependence between short and long-term rates.

The monetary authorities create the so-called monetary base, consisting of the legal tender and of financial assets which are eligible without limits for inclusion in the obligatory reserves or freely convertible into cash at the central bank. In relation to the trend of income and its distribution and to the changes in the interest rate —variables which in turn are influenced by the speed of creation of the monetary base and the channels through which this takes place— the public decides what proportion of the above-mentioned assets it will hold and what proportion it will transform into bank deposits or securities. An increase in the interest rate leads to a reduction in demand for the monetary base from the public and a growth in formation of bank deposits. According to the results of econometric surveys it seems safe to say that, between these two assets, there is a substitutability ratio capable of converting, out of present holdings, about 300 million of currency into deposits within the period of one year if there is an increase of one percentage point in their rate of return; this effect is further heightened by the action of the credit multiplier. This means that the results of a restrictive monetary policy would be much more strongly felt, but with a possibility of giving rise to the distortions which have been experienced elsewhere, if the banking system were unable to absorb, by means of the free determination of rates, as least the first impact of the restrictions, or if, at times of administrative limitations on rates, there were not available on the market a sufficient amount of short-term securities whose yield could vary according to the liquidity situation.

Since in Italy the ratios between monetary and quasi-monetary balances on the one hand, and the gross national product, on the other hand, are very high, it would appear desirable to create a more appropriate structure of yield on financial assets. A contribution to the attainment of this aim might be made by the observance of limits to the rate applicable to bank deposits; this would entail the necessity of offering the public money-market securities at rates not subject to administrative restriction and extremely sensitive to variations in market conditions, which could serve as a vehicle for the investment of liquid funds not going into bank deposits.

The deeper knowledge of our economic system and the transformations to which it is subject could not fail to be reflected in our attitude towards the possible solutions of the complex problems with which monetary policy is faced. With regard to the interest rates charged on loans and paid on deposits, our policy as expressed in the Report to General Meeting held on 30th May 1962, « has always been to prefer those types of restraint which work through agreements among the banks themselves. We have no intention of suddenly adopting the kind of intransigent attitudes for which we sometimes chide our colleagues in the banks, and we shall resist the proposals, which are often made to us, to adopt coercive controls which, in our view, are humiliating both for those who impose and for those who are subject to them ». In the same year we stressed the desirability of introducing limits on the rates applicable to inter-bank accounts. Subsequently, however, we modified this attitude and at the beginning of this year we lifted the restrictions on the determination of interest rates which can be paid on inter-bank accounts. We felt that by this measure we were giving a start to the creation in our country of a market through which the liquid funds of banks will be redistributed on the basis of the indications derived from the fluctuations in interest rates.

In the five-year period 1964-1968, under the pressure of increasingly keen competition between banks, interest rates on deposits rose at a moderate but steady pace, while lending rates showed a tendency to decline, fluctuating as the monetary situation changed in the various phases of the business cycle. In the first half of 1969 lending rates remained fundamentally stable, despite the obvious upward trend of prices; in the second half they began to increase. The rise in deposit rates quickened in the first quarter of 1970.

A survey of the data on the rates applied to bank lending operations, started in January, 1969 in cooperation with a group of highly mechanised banks which administer more than half of the country's deposit funds, revealed a continuous increase in bank financing costs from the third quarter of 1969, which became more marked at the time of the changes in the official discount rate. From an overall average of 6.81 per cent at the end of June, the figures rose to 7.51 per cent at the end of September, 7.99 per cent at the end of the year and 8.22 per cent at the end of March 1970, with a wide spread between the values observed. The rates rise gradually from the centres in the Western regions of the country to those in the East and from the North to the South, with the exception of Central Italy; the discrepancy is more than offset by the far-reaching special allowances enjoyed by the Southern regions and the islands.

The process of adjustment of rates in the second half of 1969 was faster in the case of lending rates, owing to the characteristic « stickiness » of deposit rates; this enabled banks of all sizes to achieve satisfactory financial results. On the other hand, the trend in the first months of this year suggests that, partly also owing to the heavier administrative expenses resulting from higher personnel costs, the banks' profit and loss accounts will come under heavy strain. It is quite possible that smaller banks will suffer more from this than the large ones, so that the process which, in the banking sector as in others, is driving enterprises towards concentration will receive a further impetus. We confirm that we are watching this process closely and that it is not regarded as being contrary to the public interest provided that it does not jeopardize a banking structure capable of preserving a high degree of internal competition.

In the Italian credit system the competitive factors are relatively more important than in many other countries. The revival of a latent competition in recent years probably had its origin in the economic expansion, which increased the degree of integration of the Italian economy into the international system. The recent course of monetary policy has, in turn, helped to intensify competition. Its strengthening is confirmed by the reduction in the profit per lira handled by the banking system. The rise in the cost of raising funds has been offset by rapid rationalisation, which has greatly reduced the incidence of overheads and checked the decline in unit profits.

The alignment of bond rates began in the second half of 1969; it took place in a series of sudden movements, separated by periods of relative stability. Recourse to a gradual adjustment created greater uncertainty in investors regarding future tendencies than would have been produced by an adjustment made in one single step, even though larger. The choice of method was prompted mainly by two considerations:

— an immediate adjustment might have led to a volume of bond sales beyond the monetary authorities' possibilities of control;

— the adjustment coincided with the period of unrest connected with the trade union disputes; too sharp a fall in prices might have been interpreted both at home and abroad as a sign of crisis.

The monetary authorities preferred just to reduce their interventions gradually as rates declined. At the beginning of this year it was decided to cease intervention completely, except in the case of nine-year Government Bonds. Looking at the whole period of time during which Italy has changed over from an era of stability of rates to one of variation, it is found that the average decline in prices for our bonds has been the same as elsewhere.

An examination of the trend of subscriptions for bonds shows that the expectations of impending declines in prices in our market up to March 1969 produced their first effects from the month of July, with an appreciable slackening in demand for bonds by both institutional and private investors, but without the occurrence of any major portfolio disinvestments. In particular, an examination of the behaviour of banks shows that the sales of bonds in the period of declining prices largely formed part of their normal activity as intermediaries and that the volume of bank portfolios increased, from July to December, by 362 billion.

A special situation arose in the field of mortgage bonds, which had in the previous year benefited by a tacit guarantee of repurchase at the selling price by banking institutions connected with the bodies issuing them. This guarantee, while on the one hand had made it possible to expand the mortgage bond market, had on the other hand induced among subscribers the belief that they represented a substitute for deposits—that is, that they were transformable into cash on sight. When the gap between the yield on mortgage bonds and that on other bonds became too wide, the holders of mortgage bonds, considering the sacrifice of yield excessive in comparison with the advantage of the price stability, showed a tendency to dispose of them. The continuation of support for the prices might have forced the banks engaged in the support operations to resort to financing from the Bank of Italy. In order to avoid the excessive creation of liquidity which might have resulted from this, the authorities introduced a premium which rose according to the date of repayment or, as an alternative, an increase from 5 to 6 per cent in the nominal rate on old mortgage bonds, the resultant burden being borne by the Government budget.

The decline in bond prices and the corresponding rise in actual yields were associated with the widening of the gap between bonds with higher coupons and bonds with lower coupons. The gap is due to the fact that private savers, with an eye to a possible sale of the bonds before maturity, prefer those with a higher immediate rate, since in that case they possess something certain, the coupon, as compared with an uncertain and remote factor, namely the redemption price.

With a view to defining the lines which will guide the policy of regulation of the long and short-term credit market and of intervention by the Bank of Italy in the bond market, it seems worth while to review the behaviour of the central bank during the past four years. Some people have said that the policy of supporting the prices of bonds, introduced in 1966, caused an excessive expansion of the economy's liquidity and prepared the conditions in which the current inflationary phenomena have occurred. It has been asserted by others that the discontinuance of this policy should have taken place earlier; while others, again, have stated that the policy should not have been discontinued at all.

The policy of intervention on the bond market in order to stabilize prices was introduced by the Bank of Italy in the second quarter of 1966 with the object of achieving two aims:

— to ensure the allocation to the public of new issues of substantial absolute amount, greater than was customary on the Italian market, by increasing the propensity of private individuals to invest in bonds thanks to the reduced risk of capital loss;
— to prevent a rise in domestic interest rates during a period of insufficient public and private investment activity.

Of the two aims pursued by the stabilization policy, that of the creation of a wider bond market was largely achieved. Purchases of bonds by the public in the three years 1966-1968 amounted to 1,300 billion on an annual average, against about 600 billion in the preceding three-year period, and even in 1969 they remain above 1,000 billion. Despite the unusually large volume of the new issues, the ratio between bonds placed with the public and the total of issues returns to high levels between 1966 and 1968.

The object of stimulating investment activity was only partly attained; a more aggressive policy might have been desirable, but it would have been imprudent to implement it by pushing the level of interest rates down still further, since under changed market conditions the process of adjustment would have been more difficult. When the abovementioned policy was decided upon it was not foreseen— nor perhaps could it have been— that long and short-term interest rates abroad would rise to such exceptional heights; more pragmatically, it was in fact decided to take a cautious line.

It certainly cannot be said that, during the period under review, the policy pursued by the Bank of Italy had the result of making it lose control of the process of creation of the monetary base. The latter increased to the same extent as the national income in current terms, during a period in which the price rise showed no sign of acceleration. The base created produced a growing expansionary effect because the banking system operated with a lower ratio between liquid funds and deposits, and this in fact was why the Bank of Italy, in the middle of 1969, exercised tighter control over the system's liquidity. The money volume increased at rates below those of the long-term average trend, and this development may be attributed to the stabilization policy pursued with a view to transferring the public's preferences towards bonds. This assertion does not contradict the preceding one, to the effect that the financial circuit via which firms financing took place led to the formation of large monetary and quasi-monetary balances consisting mainly of bank deposits; it merely means that the process of formation of these balances was not accelerated by the central bank's policy regarding the purchase and sale of bonds.

The critics who maintain that the policy of supporting bond prices was changed at the wrong time put forward two main lines of argument:

— they claim that the new policy was decided upon primarily in order to reduce the balance of payments deficit created by capital exports; it would have been preferable, they say, for this purpose to resort to the stricter implementation of administrative controls;

— the alignment between domestic and foreign interest rates ought really to have been brought about at the time when fluctuations, even over a wide range, in the latter appeared to indicate a downward trend; it would have been better to hold back until equilibrium was re-established at a lower level.

We believe that we have already answered both these objections; we have confirmed that it is not true that the decisions adopted in the first half of 1969 and implemented in the second half of that year and at the beginning of 1970 were inspired only by balance of payments conditions. The gradual abandonment of the supporting of bond prices forms part of the set of measures adopted by the Bank of Italy in order to exercise more direct control over the creation of the monetary base. In a period marked by growing price tensions and expectations of their aggravation owing to higher production costs it appeared desirable to put an end to the economy's possibility of obtaining a monetary base theoretically unlimited in quantity by the sale of bonds which would be automatically absorbed by the Bank of Italy's purchases.

In the first half of 1969 the outlines of the present situation were in fact becoming sufficiently apparent, this situation being one characterised by the importance assumed by the irregular behaviour of autonomous factors contributing to the creation of the monetary base, i.e., the balance of payments, preponderantly influenced by capital movements, and the Treasury. We have emphasised more than once that since the second half of 1969 the Treasury's requirements have been practically the only factor in the creation of the monetary base. It should be added that in a number of cases even the Bank of Italy's operations with the banks are due to the requirements of local authorities or social security bodies; the Bank assists those banks or central institutions which require money for this or that purpose among the large municipalities which would otherwise find it impossible to pay salaries to their own employees. Somewhat similar cases occur when the banks subsidize social security bodies so as to prevent the cessation of hospital assistance. In these cases, as in those described above, the monetary authorities' interventions have been dictated by considerations not properly pertaining to the policy they are entitled to pursue; we are convinced that under present conditions interventions of this nature cannot continue and we consider it our duty to act accordingly.

In view of the growing deficits of the public sector, which occur at irregular intervals, it would be imprudent to reintroduce a policy of unlimited support of bond prices. In case the Treasury deficit grows out of proportion to the economy's possibilities and the capital market has to be protected, partly in the interests of the Treasury itself, from the disturbances which would inevitably result, a buffer must be created between long-term securities and the rest of the financial system, so that the pressure exerted by the Treasury's requirements of funds is reflected in a rise in short-term rates without immediately affecting yield on all other financial assets. In other words, the capital market must be made more independent of the Treasury deficit so as to prevent the deficit from becoming the main factor determining long-term rates. This could be achieved by making short-term rates more sensitive, although this effect is limited by the speed with which impulses are trasmitted to the other rates in the system. An efficient money market is even more necessary when, under conditions of growing budget deficits, two further unbalancing factors come into play, one being due to the time-lag between the fund-raising operation represented by the issue of bonds and the corresponding expenditures and the other being connected with erratic movements in public requirements due to events of various kinds which administratively impede the flow of collections or of payments. As these factors are largely exogenous, it is desirable that the fluctuations which they impart to the monetary base in the short term should be reflected in variations in short-term rates, so as to restrict the extent of those in long-term rates and thus make possible the orderly operation of the capital market.

The creation of a new type of Treasury Bill for free investment, the reimplementation of Central bank policy on discount rates and on rates on advances, accompanied by the introduction of a differentation of these rates, and the liberalisation of the rates on inter-bank funds, were all measures aimed at promoting, in our system, the organisation of a more responsive money market. Over the next few months this mechanism will have to be refined; to this end the Treasury's requirements will have to be financed to a larger extent by means of money-market paper and possibly of medium-term bonds to be offered for subscription to the public at the Bank of Italy's branches at variable rates of interest. We also think that the Central Post Office Saving Funds could be financed by the issue of savings certificates bearing interest at a rate extremely sensitive to variations in money-market conditions; if the recently created Provincial and Municipal Credit Department were to place all or part of its securities with the Central Post Office Savings Fund, it would be possible to provide the money necessary for financing local authorities by resorting alternatively to capital-market or money-market instruments.

At the same time the Bank of Italy might intervene more directly to guide the banks in determining their deposit rates. This does not mean that the central bank wishes to return to the so-called compulsory cartel; the intention is rather to exert supervision on the banks coupled with a system of incentives. In the case of banks which obtain deposits by offering interest rates within the maximum limits fixed by the authorities, it would be possible to apply an increase to the interest rates paid on sums deposited in the obligatory reserves.

To sum up:

a) in view of the persistence of large public-sector deficits and the irregularity of their appearance, we do not consider it possible for the Central Bank, although continuing to purchase long-term securities, to provide an unlimited guarantee of the stability of their interest rates;

b) we consider it necessary to protect the capital market by the organisation of a money market on which the public is offered the possibility of subscribing to short-term securities the price of which varies freely in accordance with market conditions;

c) supplementing this action, and insofar as it is found possible to ensure that the public's monetary holdings are not diverted to unregulated markets, it is considered desirable that the Bank of Italy should perform the function of coordinating the behaviour of banks with regard to the fixing of rates on deposits by periodically assessing a maximum limit, related, with suitable differentials, to some of the more significant rates observed on the capital and money markets.

This action will be facilitated if the public bodies will refrain from asking the banks with which they deposit their liquid assets to pay interest rates exceeding the maxima indicated by the monetary authorities. It must be admitted that in recent times the action of public bodies has contributed to the disorder in the field of deposit rates: bodies holding liquid assets of several hundred billion lire have a bargaining power which exempts them from the limitations to which ordinary depositors are subject. When they take advantage of their bargaining power they actually increase their own funds by imposing a kind of tax, the burden of which is transferrend to the economy as a whole.

The forms of financing of the public and private sectors must be adapted to new conditions. The field of activity of bodies that can raise funds only through the issue of bonds has widened greatly and is continuing to grow. Inflationary pressures have become stronger and their appearance has led to an extension of the range of measures whereby the various social groups protect themselves from their effects.

In this situation it is increasingly essential for the financing of the public sector to be effected through the issue of bonds with yields that are more sensitive to market conditions. An example of this new trend is the ENEL loan placed abroad this month. The success achieved by this loan at time when fixed-interest securities were not finding buyers shows that, in the present circumstances, international markets attach more importance to the flexibility of the coupon, in both directions, than to a constant high level of effective yield at maturity.

The Bank of Italy regards it as its duty to adapt the organisation of the capital and money markets so as to ensure their orderly operation, and in this endeavour it will enjoy the cooperation of the banks and other credit institutions. We wish in this connection to emphasize the assistance obtained particularly from the public-sector institutions and the « banks of national interest » in the allocation of bond issues. The alignment of the yields on fixed interest securities on the Italian market with the higher levels prevailing on the international market and in other national markets gives us greater freedom of action. The Bank of Italy will check that the volume and timing of issues of securities for public subscription are consistent with the domestic and international markets' absorptive capacity. Further amounts may be purchased directly by the Bank of Italy insofar as this does not encourage inflationary processes. Should the issues offered on the market not be fully subscribed, the Bank will duly respect these limits and refrain from intervening to take up the amounts remaining unsold.

Public expenditure and credit control

In last year's Report, when examining the general economic situation at the beginning of 1969 and emphasising the improved trend of domestic demand, we did not fail to mention certain less favourable signs which were appearing in our economy and which, coming on top of the uncertainties prevailing at the international level, made it necessary for us to take great care to ensure that the line of monetary policy which we had adopted, designed to promote the continuation of the expansionary phase, should not promote inflationary pressures. In the following months the destabilising influences became stronger; the contrasting features in the economic picture became increasingly numerous and the succession of events more and more rapid, so as sometimes to give rise to contradictory interpretations which made it difficult to decide what measures to adopt.

In view of the increased expectations of inflation and of a balance of payments deficit running far in excess of the limit of about 500 billion lire —the amount declared to be maximum that could be offset by the Bank of Italy's intervention from the point of view of its repercussion on the process of creation of the monetary base— the Bank took action, in the second and third quarters of the year, to slow down that process. As at the same time there was a substantial increase in demand for monetary base by the public, the central bank's decision led to sharp reduction in bank liquidity and a slackening of the credit expansion. In the fourth quarter, partly in order to meet the persistently growing demand from the public, the creation of monetary base was speeded up again and raised to an annual rate of about 11 per cent. At the end of December the banks' liquid assets were close to their September level, the contraction in the course of the year amounting to 323 billion lire. The demand for credit was being met at increasing rates of interest.

The events of last autumn caused very serious losses in production and their effects are still being felt. Although the labour disputes were concluded by negotiations at national level, serious disagreements remained at factory level, where it is often still not possible to achieve an output matching orders. The recovery has therefore been far from complete and the failure of labour relations to return to normal is giving rise to new uncertainties. Further disputes in connection with renewals of agreements in other important sectors, such as the textile and electrical industries, gave rise to major strikes, mainly in March and April; other production losses have been caused by the general strikes held in favour of social reforms and as a protest against the cost of living. In the first quarter of 1970 industrial output was 5.2 per cent up on the same period of 1969 and in March, allowance being made for seasonal variations, only 2.5 per cent above the July 1969 peak; the preliminary data for April show a further weakening of the trend. The unsatisfactory recovery in production reduces the possibilities of reabsorption of the increased costs, and the shortening of working hours, together with the limitations imposed on overtime, results, in view of the shortage of skilled labour, in a reduction of available productive capacity.

On the demand side, the rise in the income of dependent workers will probably bring about an increase in consumption which, in monetary terms, has been estimated at an average of about 14 per cent for 1970. As for fixed investment, if the present capital investment projects of public and private enterprises are carried out, in view of the rise in prices, the rate of growth in expenditure is likely to be much higher than that forecast for private consumption, although residential building is likely to show little progress in real terms this year after the marked expansion of the last two years. There should also be a sharp rise in demand owing to the need to replenish inventories.

The Report stresses the obstacles that are encountered both in Italy and in many other countries by a policy aimed at coordinating the volume of public expenditure with the other components of demand so as to ensure economic equilibrium. The Report states that on top of the time lag, which elapses between the manifestation of the economic phenomena and their statistical recording, there is also a decision time, at parliamentary and government level, and an implementation time, at administration level. This makes it difficult to foresee sufficiently accurately the consequences of expenditure decisions which have accumulated in periods different from those in which the expenditure actually takes place.

Consideration of the period 1951-1969 leads to the general conclusion that Government departments are unable to adapt their action to the changing needs of the economy.

Only in 1965 and to a lesser extent in 1968 did they exert a substantial corrective influence on the general economic trend by contributing appreciably to the growth of income at a time when current-account in the balance of payments was showing a surplus and there were no price tensions.

In 1969 as a whole the public authorities' action was less expansionary—which seemed to be consistent with the changed situation as regards the balance of payments and prices. There was, however, an increase in current expenditure, while investment showed a substantial decline. Moreover, this expenditure was concentrated in the second half of the year and accelerated in the first few months of 1970.

If this rate of expansion were to continue, overall domestic demand, in monetary terms, would increase in 1970 to an extent far in excess of the possibilities of adjustment of supply, leading to price rises much larger than the maximum which has on many occasions been stated to be acceptable.

The price system is passing through a phase of marked strains. The prices of manufactured goods have already been discussed; in March wholesale prices were 9.1 per cent higher than a year earlier, which represents an average increase of 6.3 per cent for the year even if they were to remain unchanged for the rest of 1970; but the trend is still upwards. The rise in prices for capital goods has been particularly sharp; in March the cost of a residential building was 20.9 per cent above the value twelve months earlier. The increase in prices for machinery and equipment was also pronounced, this being a phenomenon common to the main international markets, which confirms how phases of overheating mainly affect capital goods, owing to both the greater variability of demand and the structure of supply, which is increasingly characterised by a high degree of specialisation. The price rise is less marked in the case of consumer goods, the index of which in March was 5.0 per cent higher than twelve months earlier.

The anxieties due to this state of tension, present and expected, cannot be allayed merely by the knowledge that it fits into an inflationary international context. In this connection it shoud be recalled that, although it has become customary, in considering the price policies pursued by enterprises, to relate them to the changes in prices in competing countries and although, for the economy as a whole, the idea of relative stability has now become commonplace, this concept being understood as the acceptance of an inflationary component provided that it remains within limits not exceeding the average in other countries, this does not mean that this idea can be regarded as a valid standard for any rate of price variation. Its observance could avoid balance of payments disequilibria, but it does not solve, within the country, the no less serious disequilibria which a large rise in prices creates in the distribution of income and in the formation and utilisation of savings.

It is true that in the short term the increase in prices, by improving profit formation, can assist investments; but the price rise produces a far more harmful economic effect, curtailing the purchasing power of fixed incomes earners, creating confusion in savers' preferences with regard to the various financial assets and deranging the channels through which funds flow. The financial system is thus confronted with two categories of difficulties, namely those due to the quantity of funds required in relation to the volume of additional demand and those which the price rise creates in the process of formation and channelling of savings.

It must therefore not be forgotten that we have to compare, at least in the short run, the possibilities offered by the productive system with the demand. The proportions which certain fundamental economic variables will assume in 1970 will be conditioned by events which have already occurred, including, as already mentioned, the expansion of private consumption. But the latter is a limiting factor to which the two other main components of domestic demand, the current expenditure of the public sector and capital investment expenditure, will have to adjust themselves. The fact that the pressure on resources is already excessive is shown by the trend of prices and of the current account of the balance of payments.

In the present circumstances there is therefore an alternative between investment, on the one hand, and public consumption, on the other. A contraction of the former would greatly hamper the pace of future development, with repercussions on employment and the competitiveness of Italian products, and would also mean giving up productivity gains that are necessary in order to neutralise, at least partially, the large increases in labour costs. Already in the 1960s the rise in investment was very low, constituting the most unsatisfactory aspect of the economic results of the whole decade and contrasting sharply with the development in the 1950s, when the upward trend in investment was appreciably faster than that in income. The fact that, despite this profound difference, the rate of growth of income was nearly the same in the two periods, was possible— apart from the different nature of the effects produced by the application of technological progress— by the very large extent to which advantage was taken of external economies in the more industrialised areas of Italy. Thus, coupled with the task of speeding up the industrialisation of Southern Italy, there is also the urgent need to bring the economic infrastructure up to standard throughout the whole country. It is therefore in the public sector— also owing to the unified direction of its main component, the Government— that the problem of the compatibility between the volume of available resources and the extent of the demand first of all arises, together with that of the assignment to the latter of an order of priority based strictly on the need to remedy the serious lack of infrastructure.

It may happen, however — and it seems far from improbable— that notwithstanding the gravity of the situation the necessary sense of proportion will be lacking owing to ever-increasing pressures from all sectors. Even in the last few months the Treasury, on which the financial repercussions of these pressures ultimately converge, has been assuming sole responsibility for the creation of new monetary base, although this appears for the moment to be partly due to making up for enforced suspensions of operations at the end of last year. If the growth in public expenditure could not be restrained, it would be difficult to avoid a worsening of the tensions which are at present hampering the re-establishment of real and financial equilibrium; these tensions are already going beyond the limits envisaged at the beginning of the year, which were themselves wide but in a way accepted as being inevitable and in the long run regarded as capable of being offset by future increases in production.

Prices have reached higher levels than were expected; demand for credit remains high, although its cost is rising, pushed up by investment requirements the volume of which is being increasingly influenced by the nominal component, and for which cover is increasingly being sought in sources of finance outside the enterprises concerned;

and there is continually growing demand for funds on the market for fixed-interest securities. In these circumstances it is extremely difficult for the responsible authorities to maintain control over the volume of credit, when it is left to this alone the task of regulating demand. There is an urgent need for this to be reinforced by an effective budgetary policy which, in awareness of the limits to be observed with regard to public indebtedness and of the consequences which would result for monetary equilibrium if these limits were exceeded, takes steps to spread out over time the actual expenditures, both old and new, and to ensure that they are financed in the most suitable ways, by resorting without hesitation to taxation in ways which do not hamper savings formation.

The most subtle instruments of monetary policy cannot protect the economy from the inflationary pressures that derive from public expenditure which, at all levels, tends to expand, is implemented with increasing delay, and in most cases has a destabilising effect. If the national and local communities, via their representative bodies, refuse to co-ordinate their demands for social services with the volume of available resources, and if the provision of these services continues to be characterised by inefficiency and waste, the harsh necessity will arise of enduring that most inequitous of all taxes, that is, inflation.

We ought all to remember the admonition which Luigi Einaudi gave in this same place at a difficult time which our country had to endure and overcome: « at the end of the road which, by expendiency and desire of popularity, we are induced to travel— he said— lies the abyss of destruction of the monetary unit and social chaos ». And he concluded: he who gives these warnings also wishes « to proclaim aloud the certainty that, if we will it, we ourselves shall not travel along that road ».

Gentlemen,

Our meetings in this hall take place at regular intervals of time, but although nothing changes in their formal setting, to which tradition imparts value and warmth, the document which is now presented to you here contains evidence of an evolution which is not superficial. We have no intention of opposing it, and it would be foolish and vain to attempt to do so. If anything, we are anxious that this evolution may not always be assisted, as we would wish, to the extent and in the ways which technical progress and the world around us clearly demand. These hopes seem to have a counterpart in the refinement of the research and analysis to which, not unprofitably, the group which drafts this Report devotes its efforts; but it is becoming steadily less easy, and less appropriate, to give a uniform account, if that is expected of us, of all the major happenings of the twelve months under review; this is prevented not only by the rapid and crowded succession of events and their intricate interrelationships but also by the primary need to throw light on the ideas, developments and trends which appear to be of more than ephemeral significance. Only a misplaced desire for originality could induce us to avert our attention from the phenomena which, it is widely agreed, are characteristic features of our time: either from the essentially economic matters which we endeavour to illustrate in the analytical part of the Report or from others, further from our field, on which we sometimes briefly touch in these Concluding Remarks because they seem to indicate the directions in which we are moving and could not with impunity be ignored.

For it has in fact been said that the choice nowadays is not between changing and not changing but between changing deliberately and letting ourselves be changed. If we do not reject the validity of this alternative, there follows the necessity of timely and constant participation in the far-reaching changes which are in progress and take place not by slow transition but sharply concentrated in time and thus often convulsively and with traumatic effects. Careful observation can avail itself of the aid of new and ancient sciences to obtain insights into the body of society in order to reveal the presence and nature of the processes which are establishing themselves in it and enable us to deduce, from the diagnosis, an indication of the appropriate methods of treatment. It is not likely that we shall otherwise be able to prevent disorderly and tumultuous pathological processes, in the face of which, once they have broken out, the choice seems to be confined to unfelicitous reactions —a description equally applicable both to violent repression and to belated adaptation— the last of which, by its probable irrationality and inadequacy, can hardly be expected to avoid further enforced adaptations.

But we should not venture to embark, even for a brief incursion, on a field in which the seed of philosophical speculation has already been widely sown and which, in the world, is seen to be furrowed in all directions by the implements of political action, if our country were not one of the many in which the instability of the environmental conditions combines with basic inadequacies to retard, if not to threaten, the birth and ripening of many hoped-for fruits; and, above all, if certain of these inadequacies did not lead us back into the economic sphere, presenting again to our joint attention problems which for the most part are not new but whose solution cannot be indefinitely deferred nor left to be provided by fortuitous and unforeseeable developments: for without active and prompt participation we should expose ourselves to the risks, and indeed the consequences, which we have described.

This purpose of guidance is required first of all where it can also be most fully performed, namely within a community. In our country it is still required, and with renewed intensity, for the correction of territorial and sectoral imbalances no less than for the creation of the conditions necessary for economic growth and social progress, when these are wholly or partly lacking. It is needed, to —to mention only the major tasks— in view of the choices which constitute the logical prerequisite and inevitable limit of planning, and in view of the vexed boundary line which must be observed by trade union claims within the framework of an incomes policy.

It is quite natural that in a world so rich in communications and competition many problems do not remain confined within a narrow geographical area; and we would certainly not regret this, even though the possible solutions and their modes of implementation will have to suffer the tempering effect of other sovereign wills and other interests, or just of different system. An undeniable positive effect, even for those who look askance at this permeability, this osmosis, and thus also these interdependences between nations, lies in the fact that they reveal situations calling for correction or alleviation to which they may be susceptible; such as when an unsatisfactory combination of the factors of production leads to losses of capital and labour, both attracted by more favourable prospects of employment and remuneration.

The view may be further widened to include the external relationships of a fragmentated Europe for which the only way to avoid allowing itself to be changed is by finding the strength to overcome irrational ideological allurements, thus achieving, in its larger, integrated form, in which disillusioned Europeans hardly still dare to place their hopes, those formal and technical changes which would enable it to hold its own.

This is a task which we all, in different ways, are in duty bound to shoulder if, while not rejecting the past, we are to make Italy and Europe into the land of our future; a task which requires that we should overcome the human fear of change, of transformations, and acquire the conviction that well-conceived changes, rational transformations are essential and urgent if we wish to approach that ideal state of society in which preservation of natural assets is coupled with wider sharing of the fruits of production.

In this respect, too, we must not allow time to pass by without imprinting on it the mark of our constructive will.