BANCA D'ITALIA

ABRIDGED VERSION OF THE

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FOR THE YEAR

1977

PRESENTED BY THE GOVERNOR TO THE

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1978

Concluding Remarks

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III. – THE GOVERNOR'S CONCLUDING REMARKS

A commentary on the administrative actions, the balance sheet and the profit and loss account of the Bank will be found in the appropriate chapter of the Report that has been distributed to you and to which I refer you, as in previous years, for reasons of time. As shareholders of the central bank and as credit intermediaries you are concerned in a dual capacity with problems affecting the public interest, and the leading exponents of an activity whose direction and scope are determined by that same interest. Hence, whereas the soundness of the operating accounts serves, for us and for you, to test whether the human, material and financial resources have been combined profitably in our institutions, it is legitimate that my address to this assembly should focus greater attention on the problems of managing Italy.

Before broaching this subject, however, I should like to express to the staff of the Bank as a whole the recognition that is their due for having diligently borne a work load that has continued to increase in various ways owing to the economic development of the country, new legislation and the exchange and credit situation at a time when the transfer of authority within the Bank from one generation to the next has accelerated and the number of staff has decreased by sixty-four compared with the previous year. Although the number leaving the Bank's employment has declined after having reached very high levels in the last few years, it has been necessary to institute a notable programme of recruitment, which is still in progress and has entailed the selection of entrants in a very short space of time from among an immense number of candidates.

Requests to the Bank for co-operation and consultation with government bodies have increased in step with the tendency for more frequent public intervention to guide the actions of the financial intermediaries. The Bank played a large part in the drafting of legislation concerning various banking problems. In the supervision of credit activities, increased attention was paid to the large institutions; that of foreign exchange operations involved more numerous and detailed tasks.

There was substantial growth in the work load on account of an increase in the movement of funds, measures to improve the protection of valuables and persons, and legislative requirements with regard to the reimbursement of tax credits in the form of bank drafts issued by the Bank and the payment to the Treasury Operations Divisions of salary increases resulting from variations in the cost of living.

The mechanization of the accounting operations at the Head Office of the Bank has been completed; transactions in securities via the clearing houses can now be performed automatically and in a centralized manner, so that the technical conditions now exist for the centralized management of securities.

The staff of the Bank has been called upon to fulfil these difficult tasks against the background of a reduction in the wage differentials between various groups of workers, which has meant not just a standstill in their incomes position but a serious backward step in real terms. In view of this trend towards greater equality in remuneration, which has been accelerated inordinately by the inadequacy of controls over inflation, it is imperative that the procedures for selection and promotion continue to be based on the accurate assessment of merit.

The international economy

During the recent phase of the cycle the industrial economies have failed to achieve their aim of transforming the recovery into a steady, sustained expansion of national income and trade.

In the OECD countries as a group growth slowed down during the second and third quarters of 1977 to an annual rate of less than 3 per cent. It was possible to record a real growth rate of 3.6 per cent for the year as a whole only as a result of the temporary expansionary effect of fiscal measures introduced during the summer; nonetheless, this was still below the rate recorded the preceding year (5.2 per cent) and insufficient to permit adequate utilization of the factors of production. The number of unemployed rose above 16 million, almost half of whom were under 25 years of age. The increase in fixed investment remained below that recorded in previous post-war upswings.

The rate of inflation, measured in terms of retail prices, exceeded by about one-half of a percentage point the rate of 8.7 per cent registered in 1976. Although slight in itself, this acceleration thus came on top of a rate that was already too high, albeit well below the peak of 13.6 per cent reached in 1974. With the rise in wages slowing down slightly, from an average of 11 per cent in 1976 to 10 per cent last year, the smallness of the growth in output hindered a further reduction in the rate of inflation by holding back gains in productivity and exacerbating the increase in unit labour costs, which rose by an average of 6 per cent in the manufacturing industry of the major countries, compared with 3 per cent in 1976. The Italian economy was a factor in the calculation of this average, but a widely divergent one; in Italy the increase in unit costs was three times that recorded in the other countries as a whole, in spite of the assumption of social security contributions by the State.

The sluggishness of the expansion is largely attributable to those countries whose favourable balance-of-payments position would have allowed a more rapid increase in production. Domestic demand expanded according to plan in the United States but at a slower rate in the Federal Republic of Germany and Japan. The current-account surplus was maintained in the first of these latter two countries and increased in the second.

In view of the rise of only 4 per cent in world trade, the deficit countries were able to improve their external accounts only by holding growth down to half the rate they had recorded in 1976. The slower development of world trade was also partly due to the weakness of the expansion in the economies of the socialist countries and to the insidious resurgence of protectionist tendencies which, in turn, have their origins in the low rate of growth. As a result of the high level of unemployment, the restructuring of the economy entails economic and social costs that are considered excessive; the change in the relationship between the prices of industrial products and those of raw materials and the successful development of new centres of industrial production may, however, render such restructuring unavoidable.

At the international level the attempt to set the world economy in motion again first took the form of assigning to the United States, the Federal Republic of Germany and Japan the role of " locomotives " of the expansion; in the case of the last two countries named this entailed achieving a more rapid rate of growth than those responsible for economic policy could attain or felt able to pursue. Towards the end of the year a second phase began; a less marked contrast of roles was sought by proposing concerted action to sustain demand in which a large number of countries would participate but to differing degrees.

The need for better co-ordination among the major economies derives not only from cyclical factors. Although the current-account surplus of the OPEC is showing a tendency to decline quite apart from the fluctuations to which it is subject as a result of variations in economic activity in the industrial countries, it continues to be the determining factor. Against the background of worsening terms of trade and difficulties in the reallocation of resources that is common to all the industrial economies, the major countries remain confronted with the problem of defining economic policies whereby the current-account deficit can be distributed within the OECD area in a way that ensures the optimum utilization of resources and encourages the process of capital formation.

The fall in investment in 1974-75 reflected the depth of the recession; monetary stabilization policies and households' increased preference for liquidity heightened the financial risks facing firms and contributed to the decline in the rate of capacity utilization. Subsequently the recovery in capital formation was hampered by the persistence of poor profit expectations and general uncertainty concerning the stability of both the volume and the composition of demand and the relative prices of manufactured goods and factors of production. The structure of financial liabilities had a less marked effect; since 1975 companies in many countries have been able to bring the ratio of liabilities to assets closer to equilibrium. In this respect, too, Italy constitutes an exception.

It would appear that action should be undertaken at several levels simultaneously to escape from this situation and give fresh impetus to private investment; measures should be adopted to promote more sustained and steadier growth in overall demand, to reduce uncertainty concerning the trend of labour costs by exercising restraint through incomes policy, to determine some of the broad lines of the composition of demand by modifying the structure of public expenditure and to gear fiscal policy to a recovery in investment by expressing the incidence of taxation on gross profits in real terms.

The differences that have existed hitherto in the criteria applied in the management of domestic demand have led to disequilibria, the most striking expression of which last year was the current-account balance-of-payments deficit of the United States, estimated at 20 billion dollars, more than the total deficit accumulated in the five-year period from 1970 to 1974. The impact of the cyclical disparity between the United States and the other major economies was compounded by the effect of structural factors, the most important being the increase in the energy deficit, which was reflected in the growth in the value of US oil imports from 3 billion dollars in 1971 to 41 billion in 1977.

The dollar consequently came under strong pressure, which was accentuated by very large capital flows, particularly in the final quarter of 1977 and the first quarter of this year. The weakness of the dollar had various effects on interventions in the foreign exchange market, the cost of oil supplies and the international credit markets.

On the foreign exchange market the decline was cushioned by large-scale support operations carried out by the central banks of the surplus countries — notably the Bank of England, which financed about half the official deficit of the United States — and, in the opening months of 1978, by the US authorities.

The appreciation of a number of currencies, including the yen, the Swiss franc and the deutschemark — which was partly induced by capital inflows — was far larger than was warranted by the lower rate of inflation in the countries in question and thus led to a decline in their competitivity, causing contractionary pressures and checking the impetus of their endogenous recovery.

The decline in the US dollar did not provoke parallel increases in the dollar price of oil, as the sluggishness of the world economy together with the exploitation of new deposits had resulted in a temporary excess of supply over demand.

Owing to the exceptional expansion of the international financial markets, the US dollar not only maintained but actually increased the role it plays in credit operations: in these markets four-fifths of the present volume of bank loans outstanding and three-fifths of the securities issued in the last four years are denominated in dollars. The fall of the dollar led to an appreciable redistribution of wealth at the world level. The real value of deficit countries' debt declined; the problem of international indebtedness was thus mitigated to some extent during 1977, partly because, with a decline in the OPEC surplus, the large US deficit allowed a reduction in those of other countries, notably the non-oil developing countries.

The precariousness of the equilibria achieved last year was inherent, moreover, in the fact that the reduction in the oil burden and the fall of the dollar were associated with the unsatisfactory rate of growth in the world economy. A further devaluation, if it were expected by the market, might lead to a gradual reduction in the role of the US currency as an international unit of account; on the other hand, in their desire to avoid losses the holders of financial assets denominated in dollars might diversify on a large scale, as they have recently shown signs of doing. Substantial shifts in the currency distribution of the existing volume of international liquidity would lead to serious, perhaps unmanageable market instability. In expanding their international intermediation of funds, the banks have channelled vast sums through financial mechanisms which are highly elastic with regard to the expected yield, not subject to standardized quantitative or qualitative controls and lacking a clearly defined, responsible lender of last resort. Furthermore, the international system of banking intermediation has undertaken considerable maturity transformation in order to meet both the depositors' marked preference for liquidity and the actual requirement of many countries for long-term financing.

The argument that the growth in official liquidity has fed worldwide inflation does not appear to be well founded. Flexible exchange rates have meant that monetary expansion and inflation are again determined at the national level, so that it has been the surplus industrial countries that have recorded the most marked slowdown in price and cost increases. Moreover, the jump in the price of oil forced the monetary authorities of many countries to offset the deflationary effects of their emerging deficits by resorting to official borrowing. Whereas previously deficits were settled by drawing upon reserves, now they are to a large extent financed by incurring debt.

In the absence of co-ordinated policies with regard to the recycling of funds, the banks' indebtedness vis-à-vis the international financial market has had a counter-deflationary rather than inflationary effect. Fears that private credit, inasmuch as it is unconditional, would delay the process of domestic adjustment in the deficit countries also proved to have been exaggerated, as the banks avoided granting loans to those countries that showed little sign of returning to internal and external balance.

While thus assessing the situation favourably, it is not our intention to minimize the problem of the intermediation of funds or that of the creation and utilization of international liquidity. In last year's Report emphasis was laid on the need to expand the role of the official portion of international credit flows and to restrain the process of maturity transformation. Attention was drawn to the need for agreements establishing a sound relationship between financing mechanisms and the aims and methods of domestic adjustment. In these circumstances an agreed programme of action should be adopted with regard to the distribution and use of international liquidity aimed at regulating the volume and nature of official reserves reinvested in private credit markets in view of the " high-powered " liquidity that continues to flow from the official US deficit.

Recent experience would seem to prove that movements in exchange rates cannot resolve the problems of liquidity and structural adjustment at one and the same time, as the advocates of floating rates had claimed. The evidence available does, however, appear to be consistent with the arguments of those who maintain that flexible exchange rates can contribute to the process of adjustment but are not capable of inducing stabilizing capital flows of sufficient size to eliminate the need for official liquidity. In these circumstances it is understandable that efforts should be made to establish the conditions which allow progress towards arrangements for limited flexibility linked with changes in the mechanisms whereby international liquidity is created and distributed. In view of the urgency of these problems, they have been studied in greater depth both at the world level under the auspices of the International Monetary Fund and at the European level within the Community.

The arrangements for the provision of liquidity and finance within the Community have already been extended. Proposals are now under examination for further increasing the funds available under both the short and medium-to-long-term financing arrangements embodied in agreements that will be developed further regarding economic and monetary co-ordination and exchange relationships both within the Community and vis-à-vis the other principal currencies. Recent experience and discussion of the lessons learnt have demonstrated clearly that if there is to be a European option each country must follow incomes, budgetary and monetary policies that are compatible with a gradual stabilization of exchange rates. The European policy of integration thus entails choices, responsibilities and prospects that directly involve not only the monetary authorities but all sections of society, so that an overall framework of consistent policies can be determined and maintained over a period of time. The new arrangements proposed for encouraging the convergence of exchange rates at both the European and world levels must take account of underlying economic realities, as the fate of proposals made in the recent past demonstrates only too clearly.

In the year that will see the election of the European Parliament by direct suffrage tangible results should be achieved in the process of monetary integration; in this way the foundation would be laid for a polycentric system which seems to be more in keeping with developments in international financial relationships, in which the ability of individual countries to assume a leading role has proved to be short-lived or inadequate.

The exchange rate

In the aftermath of the serious foreign exchange disorders that had occurred in 1976, last year opened with the prospect of an adjustment in the Italian balance of payments. The expectation of a more orderly exchange rate performance was also based on the restraining influence that the measures brought into effect in the closing months of 1976 would have on demand and credit.

Some uncertainty remained concerning the way in which the market might behave during the gradual dismantling, in the first few months of the year, of the emergency measures that had in various ways brought about a temporary increase in the cost of foreign exchange.

Experience during the period immediately preceding the year under review had confirmed that in the conditions prevailing in Italy the effectiveness of exchange rate changes as a balancing force is limited in both degree and duration; after a small initial gain, the rapid adjustment of domestic prices to the new exchange rate tends to cause a shift to a higher rate of inflation.

In view of this close relationship between prices and exchange rates, the overall stability in the external value of the lira achieved last year played an important part in the control of inflation. The use of direct instruments of monetary management and the maintenance of relatively high interest rates helped to increase the supply of foreign currency stemming from borrowing abroad.

Moreover, the strengthening of the foreign exchange reserves played a part in kindling and sustaining favourable expectations regarding exchange rate developments. The same effect also derived from the considerable degree of stability in the external value of the lira implied in the macro-economic framework agreed in the spring with the International Monetary Fund and the European Economic Community in the course of negotiations that resulted in the granting of fresh loans.

At the beginning of the year the termination of the emergency system of foreign exchange safeguards was still giving rise to some tension; in February and March intervention sales totalled 550 million dollars, although a large part of this amount was offset by substantial foreign investment in Italy. The net demand for foreign currency was met without significant effects on the exchange rate. In April and May the first appreciable inflows of currency were recorded as a result of the increase in net fund-raising abroad by the banking system. In June the improvement in the foreign exchange position, the approach of the favourable season of the year and concern at the large foreign debts accumulated by the banks made it advisable to relax the requirement for exporters to obtain financing in foreign currency.

From then until November the exchange rate remained practically stable and the notable additions to the official holdings of foreign currencies resulted from the emergence of a surplus on the current account of the balance of payments. The resilience of the lira was confirmed by the virtual disappearance of the parallel market and the reduction in the forward discount. In these circumstances other exchange controls affecting tourism and the circulation of Italian bank-notes abroad could also be relaxed.

In December the current account continued to show a surplus but the advent of uncertainty about the political and social situation cast a shadow that affected the exchange rate in spite of the control exercised over the market. Hence, whereas the weighted rate of depreciation since February 1973 increased from 37 to 38.4 per cent in the first eleven months of the year, in December alone it deteriorated by one and a half further points. A contributory factor was the widening of the divergence between the balance of payments of the United States and those of the strong countries, which caused the currencies of the latter to appreciate rapidly.

Throughout last year the lira remained more or less stable in relation to the dollar. The decline in the exchange rate weighted in terms of imports was smaller than that on the basis of export weightings because of the greater importance of the dollar in the former. This brought about some improvement in the competitivity of export sectors at only a small cost in terms of domestic inflation.

At the end of 1976 the liquid foreign exchange reserves had amounted to 2.8 billion dollars, which was 200 million less than the banks' net external liabilities; a year later the reserves totalled 7.9 billion and exceeded net bank indebtedness by 1.2 billion. The balance-sheet value of gold holdings at the same date stood at 11.3 billion dollars.

This outcome was due to the current-account surplus of 2.3 billion dollars that accrued during the year and, to an even larger extent, to inflows of short-term capital through the banking system induced partly by the differential between domestic and foreign interest rates and partly by the restrictions placed on the growth of lending in lire, which shifted some of the demand to loans in foreign currency.

This demand turned to the international market, where the large US deficit had created an abundance of available liquidity and at the same time had weakened the dollar so that borrowers were willing to incur short-term debt in that currency; indeed, by taking up such loans Italian importers felt able to dispense with forward cover in many cases.

With inflation still running at too high a rate, the only alternative that could reasonably have been proposed to the exchange stabilization policy pursued last year was a reduction in intervention purchases, thus allowing the lira to appreciate and giving priority to the control of inflation over other objectives. While not neglecting this aim, the line of policy adopted combined its attainment with that of two others that were considered essential.

The first of these was to increase the reserves to a level in keeping with the scale of Italy's foreign trade, now approaching 100 billion dollars per annum, the requirements in connection with the imminent maturing of large foreign debts and the need to counteract sudden large-scale shifts of capital caused by unpredictable factors, some of them outside the economic field. The dimensions of the international foreign exchange market are such that a relatively small movement concentrated on one or a small number of countries is sufficient, particularly if their currencies are weak, to cause disturbances that can be controlled only by expending a considerable amount of foreign exchange.

The second aim is to maintain the competitivity of an economy that exports around one-half of its industrial output. An intervention policy tying the lira to the currencies of countries with rates of inflation far lower than that prevailing in Italy could not possibly have exerted a sufficiently moderating influence on prices to validate *ex post* the resulting exchange rate trend. The less ambitious policy that was pursued consisted in maintaining the lira rate close to those of the other two major European currencies that have broken away from the currency " snake ", thus dissociating themselves primarily from the deutschemark.

In the first four months of this year intervention purchases, at 1,300 million dollars, have continued to be far greater than sales. The banks' net indebtedness fell during the same period from 6.6 to 6.4 billion dollars. Liquid foreign exchange reserves declined from 7.9 to 7.4 billion dollars as a result of the repayment of foreign debt. At the end of April official holdings of gold and foreign exchange totalled 20.7 billion dollars and exceeded liabilities (official liabilities, net bank indebtedness and compensatory loans) by 2.6 billion; this contrasts with the period from June 1975 to November 1977, when liabilities had exceeded assets.

Contrary to the assertions made in some quarters, the massive debt repayments are not symptomatic of a policy that pays scant regard to the need to channel funds from abroad towards financing productive activity. In the present circumstances residents have been able to take up foreign loans on their own initiative without opposition from the authorities and subject to control only to ensure that the conditions of the loans correspond to those of the market. In this manner new loans totalling 700 million dollars have been raised in the last eight months. If after having returned to a satisfactory foreign exchange position Italy had requested postponement of its debt repayments, it would have prejudiced its chances of resorting at a later date to official and private sources of short and long-term foreign finance and of keeping the funds that had already flowed into the country.

The outlook for foreign exchange management this year depends essentially on two factors, one certain and one that can be estimated. The former relates to the concentration this year of maturing loans totalling 4 billion dollars, of which 3.5 billion (more than one-third of which was repaid in March) are owed to central banks or international institutions. The second concerns the current-account surplus which, according to the economic programmes for this year, should amount to at least 2-2.5 billion dollars, a figure which in all probability will be achieved in view of the good performance registered in the first quarter and the favourable seasonal nature of the coming summer months. Nevertheless, it is possible that the trend of the relative rate of inflation in Italy and the present recovery in output will have a negative effect on the balance of payments as the year proceeds.

The loan repayments that are not covered by the current-account surplus could be financed by drawing upon reserves or by incurring fresh indebtedness in the form of short-term trade and bank credits or medium and long-term loans.

The proceeds from the two sources of short-term finance depend upon a large number of variable factors that can only partly be controlled internally. In some circumstances changes in bank indebtedness in particular may become a cause of instability in the exchange market and in the level of reserves; indeed, in recent months the proportions and direction of interventions by the Italian authorities have been strongly influenced by movements of funds induced by frequent changes in expectations concerning the dollar and by domestic and international events in the political arena.

With regard to medium and long-term loans, foreign markets appear to be willing to provide Italy with refinancing, albeit with some degree of caution. Their attitude is influenced, however, by the assessments made by the international institutions to which Italy has applied or is applying for loans. There is therefore no distinction, except in theory, between conditional and unconditional lending. For this reason, too, it is necessary to act in a way that leaves open the possibility of recourse to the IMF and the EEC.

The need to pursue an economic policy that takes account of the balance-of-payments constraint assumes added importance in conditions in which external disequilibria cannot be corrected by exchange rate manipulation without giving fresh impetus to inflation, which would condemn the exercise to failure and, indeed, cause it to have a perverse effect.

The economic situation

The performance of output and prices during 1977 was shaped by the fiscal and credit measures and changes in public utility charges adopted from the autumn of 1976 onwards in order to regain control of the serious situation that had arisen owing to the magnitude of the accumulated internal and external disequilibria and, more particularly, to the danger of a further deterioration.

Once the fall in the exchange rate had been halted the rate of inflation slowed down. In view of the large volume of imports of energy products and raw materials, the prices of which were stabilizing on world markets, the dampening effect was most evident in wholesale prices; the rate of increase moderated from 31.5 per cent in the period between December 1975 and December 1976 to 9.5 per cent in the following twelve months. A smaller but still substantial slowdown occurred in consumer prices, where the rate of increase came down from 22 per cent in 1976 to 14 per cent in 1977 despite the rise in public utility charges and regulated prices.

The fiscal measures and changes in public utility charges introduced under the stabilization programme, which were designed to produce additional net revenue of 5,000 billion lire in a full year, made inroads into households' disposable incomes and caused a slowdown in consumption from the first quarter of the year onwards. Domestic demand first lost the impetus that had been evident in the closing months of 1976 and then weakened rapidly owing to the cyclical turnround in inventories. Producers looked to exports to offset the fall in domestic sales, but although they succeeded in increasing their market shares their expectations were not fulfilled because the expansion in world demand was weaker than had been forecast. The decline in the rate of capacity utilization and the worsening of financial difficulties at a time of dwindling opportunities for self-financing brought investment to an abrupt halt. In February industrial production began to decline, and it continued to fall during the months that followed, reaching a low point in June, when it was 12 per cent below the level recorded in January. In the autumn the contractionary pressures subsided, fading away completely towards the end of the year; the rate of registered unemployment rose to 7.4 per cent.

Although the trend of industrial production in 1977 contrasted with that of 1976, the annual average for 1977 was still slightly higher than that for the previous year. However, its effect on national income was almost neutralized by another bad year for agriculture, with the result that the 1.7 per cent increase in gross national product was mostly attributable to the services sector.

In addition to the immediate goals, the objective of the stabilization programme was to launch a policy which would again give the economy scope for faster growth, which had been impeded by the worsening of the terms of trade as a result of the oil crisis.

Assessed in this light, last year's results are unsatisfactory and disturbing. We have not succeeded, nor are we anywhere near to succeeding, in shifting domestic demand from consumption to investment; this is the necessary condition for setting in motion the virtuous circle which will increase productivity, produce a lasting improvement in foreign trade and allow a larger and steadier expansion of domestic demand.

The truth is that in the short run the anti-inflationary policy was bound to have an adverse effect on private investment; moreover, exports have not increased plant utilization by as much as had been hoped. However, it is also true that there has been no increase in expenditure on public works nor have the measures been introduced that might have improved the propensity of firms and households to invest. State enterprises further reduced their investment in manufacturing industry and kept it unchanged in the services sector. The decline in house-building that began in 1974 continued. Only in the electricity supply industry did investment increase appreciably. On the whole, the ratio of gross fixed investment to gross domestic product declined further, to 17 per cent from 21.3 per cent in 1970.

Even the reversal of the sign of our external accounts seems to be largely due to cyclical factors. Approximately one-quarter of the improvement in the trade balance can be ascribed to a 2 per cent gain in the terms of trade, after the deterioration of 25 percentage points that occurred between the end of 1972 and mid-1974; in addition, the containment of imports was to a large extent due to the considerable reduction in stock-building.

The success recorded in the fight against inflation, though considerable, also seems to have been attributable to nothing more than a combination of cyclical or chance factors, such as the sluggishness of domestic demand, the absence of major labour contracts due for renewal and the disappearance of the external causes. This is confirmed by the fact that in recent months the continuous rise in consumer prices has slowed down to a rate very much below that recorded twelve months ago, but still well out of line with those of Italy's major competitors. The forecasts all indicate a rise in consumer prices of around 13 per cent in 1978, that is to say only slightly below last year's rate, even taking into account the lack of further exogenous pressures stemming from international prices. In the other EEC countries price increases are expected to average 5.8 per cent, with a peak of 10 per cent in the United Kingdom and Ireland.

The fact that the slowdown in price increases has petered out while inflation is still in double figures again calls for reflection on the forces of inertia which sustain the upward trend when its original causes have disappeared.

The concentration of contractual pay increases within a brief period of time and, more generally, the drive towards a redistribution of income and wealth at the domestic and international levels lead to increases in the general price index, which are directly proportional in size and duration to the two parameters of indexation: the degree of coverage against inflation and the frequency of the cost-of-living wage increases.

Under the present system the adjustment of wages for price rises affords about 85 per cent coverage, and when no increases are made in contractual pay — which in the present economic situation would be difficult to reconcile with monetary equilibrium — it tends in time to approach 100 per cent. Moreover, the adjustment is made within the space of one quarter.

Statistical analysis shows that an autonomous inflationary push is prolonged by the inertial forces inherent in the sliding scale to the extent that over a two-year period it raises the price index by about a third more than it would if the adjustments were made annually. This calculation, which probably underestimates the slowdown in inflation caused by the induced effects of a reduction in interest rates, presupposes that the transfer of cost increases onto prices is slow and incomplete, as has been the case in recent years. However, fresh exogenous cost pressures are unlikely to be absorbed by profits to the same extent, and when they are deflected onto prices at the same speed and intensity as those emanating from the sliding scale the initial push will continue to reverberate until it has produced, in the space of two years, induced inflation at almost twice the rate that would be caused by annual adjustments. If domestic or international competition were to prevent such a transfer, the impact on the ability of firms to survive and on employment would be all the harsher.

When the incomes of all employees are adjusted by the same amount for each point increase in the cost-of-living index, as is the case in Italy, a large part of the process of reducing wage differentials depends not on rational decisions reached by the bodies representing the community but on the speed of inflation, which these mechanisms themselves promote but which may also be triggered off by chance factors, such as a bad harvest, a deterioration in the terms of trade or a fall in the exchange rate due to unfavourable expectations.

However, if for various reasons — which no amount of analysis can show us to have any justification on the grounds of protecting the interests of the working population and to which we cannot therefore give even a modicum of intellectual support — the present wage indexation system were to be retained, it would be necessary at least to take steps to avoid, as far as we were able, giving any extraneous stimulus to prices. Inconsistent with this need was the fact that in 1977 gross per capita wages rose by 25 per cent, which represents a 6 per cent improvement in terms of real earnings, whereas gross output per worker increased by 1.3 per cent. A comparison restricted to the EEC shows that in the same year wages in the Federal Republic of Germany increased by 6.9 per cent at current prices and 2.9 per cent at constant prices; in the United Kingdom they rose by 10.1 per cent in nominal terms and decreased by 3.7 per cent in real terms.

The impending renewal of major labour contracts again raises the problem of whether wage changes can be made without regard to price stability, the growth in investment and the scope for increasing work opportunities.

In recent years income redistribution in Italy has been too rapid for production and investment to remain profitable, particulary as it has coincided with a serious deterioration in the terms of trade which has weighed most heavily on firms.

As a consequence, a growing percentage of the population has been in various ways either deprived of the chance to work or excluded from the official labour market. The industrial sectors where recourse to the Wage Equalization Fund is proportionally highest — now equivalent to the work of 200,000 full-time employees — and where " grey " or unregulated employment is most prevalent are the very ones where the rise in wages has been fastest owing to the wage equalization policy, which consists in granting equal increases to all workers both under the sliding scale system and under wage agreements. In fact, too fast an increase in labour costs produces effects which frustrate or distort egalitarian intentions: the economy becomes incapable of creating sufficient opportunities of work for young people and tends to overcome the rigidities embodied in agreements between management and the unions by splitting up the production cycle, paying wages below contractual rates and evading the social security contributions and obligations arising from the statutory requirement to provide for the welfare of the working population, thus reverting to pre-industrial methods of production.

Far from being an independent variable, average wages are determined, in the final analysis, by these diverse reactions on the part of the economy.

Only at the cost of large sacrifices can the restriction of aggregate demand or of the money supply slow down the rise in prices when no help is forthcoming from action to regulate unit labour costs in one of the forms possible: an incomes policy in the narrow sense, a " social contract " or agreements on productivity and labour mobility.

It will not be possible to maintain the already slow progress towards greater price stability if the labour contracts to be concluded in 1978 and 1979 contain economic and legal provisions that will produce further increases in real wages or lead to an expansion in the public sector's current-account deficit by transferring costs to the community. Furthermore, changes in the wage structure and in the mechanisms for adjusting them automatically should strengthen, at national, sectoral and company level, the link between remuneration and the economic and professional value of the work performed, thus reversing the tendencies which have taken hold in recent years and which might still prevail if insufficient attention is paid to the gravity of the resultant disequilibrium.

Both the average cost of labour and the spread of costs for different groups of workers, firms and sectors can be altered; the timing and the extent of the changes are limited, however, by the composition of the labour force, its geographical distribution, the quantity and quality of industrial equipment, the institutions and the very system of cultural and professional values. None of these conditions is immutable but none can be modified rapidly and without cost; when the room for manoeuvre that they allow is exceeded — even in order to achieve greater equality or a faster improvement in the standard of living — inflation and unemployment appear as the pathological manifestations of an unresolved conflict over distribution.

In the conditions currently prevailing in Italy social transfer payments constitute another factor of monetary instability. They are the main cause of the increase in current expenditure by the public sector, which totalled 43.4 per cent of gross domestic product last year compared with 37.7 per cent in 1973. Since revenues have increased proportionately less despite the succession of fiscal measures, the current deficit has risen from 3.8 to 4.9 per cent of gross domestic product.

Demographic factors and regulations deriving from current legislation concerning the eligibility for benefits and their indexation to prices and wages will lead to a further rise in expenditure on pensions in the years to come. The share of GDP allocated for this purpose is expected to increase from 11 per cent in 1977 to 13-14 per cent in 1979 and then to 18-20 per cent in 1990; since the price elasticity of pensions will be above unity until the early eighties, the higher the rate of inflation during this period the greater will be the increase. The cost will tend to rise most between 1978 and the beginning of the eighties owing to the planned increase in the cost-of-living adjustment for certain pension funds, a rise in the number of pensioners and earlier institutional changes.

Expenditure on health services will also place a considerable added burden on the budget, especially if the reform bill at present before Parliament is approved in its present form. In fact, this bill displays no evidence of a clear desire to control the demand for services, improve the quality of the services offered and hold down running costs.

Some adjustments in expenditure procedures proposed in recent weeks tend in the right direction. Others are necessary, both in the area of social security and in that of health services, to limit the collection of several pensions, restrict indexation to restoring purchasing power and prevent the wastage of medicaments and the abuse of services. This undertaking, which should proceed in parallel with a more determined fight against the evasion of taxes and social security contributions, could lead to a reduction of the deficit while bringing about a more just distribution of incomes and allow the gradual implementation of a public expenditure policy that reflects more directly the demand for social goods and services and to which a planning effort could profitably be applied.

The shortage of hospital, social security and educational facilities is compounded by the damage caused by the crisis that has long affected the building industry owing to sometimes inappropriate legislative changes and uncertainties regarding their application: the number of houses completed, which had averaged 343,000 a year during the sixties, dropped to 148,000 in 1977. Consequently an important component of demand that has a low import content has been constricted.

The straitjacket of inflation

A summary of the economic trends we have been describing could open with the observation that the decline in output last year was less pronounced than that in the preceding recession. Between the third quarter of 1974 and the same quarter of 1975 — the twelve-month period during which the downswing occurred — the fall in industrial production had amounted to 13.6 per cent and that in national product to 4.5 per cent; figures relating to the period from the final quarter of 1976 to the same quarter of 1977 show a decline of 7.6 per cent in industrial production and one of 1.4 per cent in national product. The increase in unit labour costs in industry (excluding construction) came to 41 and 21.5 per cent in the two periods respectively; the latter figure represents the actual cost, including the social security contributions taken over by the State.

This still high rate of increase in labour costs during a downturn confirms that in Italy measures to combat inflation consisting solely of monetary and fiscal restrictions also cause a sharp reduction in the flow of real resources, thereby increasing the potential for inflation stemming from unit costs. If it is not corrected promptly, the rise in costs will quickly upset the internal and external monetary balance re-established after the traumas of 1976.

The difficulty in holding down unit costs even outside periods of recession has been exacerbated by the universal slowdown in the rate of growth in the seventies. In the twenty years from 1950 to 1969 the national product of the group of OECD countries grew at an average rate of 4.7 per cent per annum in volume terms, whereas in the following eight years the rate of growth averaged 3.4 per cent. The average rate of inflation rose from 3.3 to 7.9 per cent between the two periods. In the case of Italy the change for the worse was, unfortunately, more pronounced — real growth in national income fell from an annual rate of 5.7 per cent in the first period to one of 3.1 per cent in the second and the rise in prices leaped from 3.6 to 13.0 per cent.

Italy is thus more tightly constrained by the straitjacket of inflation and the country has not only lost all of the growth advantage it previously enjoyed, but has fallen behind. In a context different from that of today it was possible to argue that inflation encouraged growth on the grounds that the fall in the value of the currency would lead to an increase in the share of national income accounted for by profits at the expense of wages and to a transfer of wealth from creditors to debtors — both of which processes would stimulate investment — and would create a fiscal instrument capable of financing public expenditure and, in particular, public investment that would not otherwise be possible for governments that lacked an efficient system of taxation.

The first kind of redistribution could occur in an economic environment in which wage bargaining was relatively unco-ordinated and money illusion was prevalent. In the present situation of Italy, however, where the indexation arrangements have a degree of coverage and a frequency of adjustment that are among the highest in the world, the existence of money illusion is absolutely implausible: in fact, in times of inflation there is a tendency to overestimate the future increase in prices and thus to make disproportionately large adjustments when renewing wage contracts.

With regard to the second form of redistribution, it is true that disorderly wage increases, which have been inconsistent with the real growth potential of the economy, have generated rising financial surpluses in the hands of households and that their holdings of financial assets have fallen dramatically in real terms as a result of the increase in prices, which has not been offset by an adequate rise in nominal interest rates; the bite of inflation has been such that the real value of households' financial wealth declined from 98,000 billion lire at the end of 1973 to 92,000 billion at the end of 1977, in spite of the capitalization of interest and the flows of new savings. It would, however, be a grave mistake to assume that the experience of the period 1973-76 could be repeated. The outbreaks of inflation during the war and in the immediate post-war period were followed by more than twenty years of relative monetary stability; coming in the wake of this, the recent burst of inflation was to some extent unexpected and it seriously undermined the climate of confidence that had been created, as illustrated by the drying-up of voluntary investment on the stock market and the growing preference for liquid assets, the yield on which reflects market conditions in that it includes allowance for the average rate of inflation.

Finally, it is also true that the tax levied by inflation on the holders of public-sector debt and on the monetary base has constituted a rich source of government revenue in recent years; however, this surreptitious and profoundly unjust tax has not promoted the financing of socially rewarding public investment programmes; instead, it has helped to compensate for shortcomings in the management of public affairs caused by inefficiency, waste and misguided welfare policies. In order to draw up serious economic policy programmes and define the boundary between the aspirations of the community and the public sector's eventual ability to satisfy them, however, it is necessary to introduce fiscal instruments that will allow a return to democratic control of receipts and expenditure and to a direct comparison between the two, thus making it immediately possible to verify that the chosen budgetary criteria have been observed and determine the costs and obligations that the community must accept as a counterpart to public expenditure.

A close examination of the relationship that exists today between inflation and growth reveals the hollowness and hypocrisy of proposing to overcome the present difficulties by means of inflation. In addition, both theoretical arguments and the fact that domestic raw materials and sources of energy are in short supply demonstrate the folly of those who urge the adoption of policies based on autarky and protectionism.

In an index-linked economy that is highly dependent on foreign trade, in which price expectations tend to be excessive and in which the stock of financial assets is declining, the areas available for absorbing inflation shrink to practically nothing and every stimulus to recovery falters if it is not accompanied by a strategy for re-establishing monetary stability, encouraging capital formation and developing human resources.

The problems of financial reorganization in the corporate sector

The formulation and implementation of budgetary and labour policies consistent with the objectives of steady growth in national income and employment is a general prerequisite if new schemes for intervention to help re-establish equilibrium in individual sectors and companies are to have any sense.

Last year's Report dwelt at some length on the financial difficulties of the corporate sector. Since then the Government and Parliament have taken steps in their respective spheres to resolve a number of problems, such as those arising from the double taxation of dividends. In other areas there has been delay in moving from discussion to legislative action, the need for which becomes more pressing with each day that passes. Nonetheless, the debate has served to identify a number of points on which there is a broad consensus of opinion.

One of these is the recognition of the indispensable function performed by economic agents outside the credit system, be they individuals or corporate bodies, as ultimate subscribers of equity capital. Another, however, is the definition of the temporary role credit institutions can play when the funds from these sources prove to be inadequate and a more far-reaching adjustment is required: the credit institutions should confine their intervention to the financial sphere and assume no direct responsibility for company management, they should not acquire interests in excess of their uncommitted net assets and the precise form of corrective action should be decided case by case within a general framework of rules, with all the parties involved accepting full responsibility.

Fiscal policy is generally recognized to be the most suitable means of providing support commensurate with the operations the authorities wish to promote. On the other hand, the proposal that joint-stock consortia should be established to intervene on behalf of the credit institutions has attracted criticism based on the concern, which the Bank shares, that the size of interventions should be limited and their private nature safeguarded. The Bank nonetheless considers that direct subscription of equity capital would make the necessary co-operation among creditors more difficult to achieve, cloud the transparency of interventions, negate all distinction between the management of credit intermediaries and that of companies and, since there is no provision for general controls, increase the likelihood of unco-ordinated and interested interference in individual cases.

The proposal to set up consortia is designed to provide an instrument and not a solution that is universally applicable; whether it is used effectively will depend on the initiative, judgement and ability of the managers of the credit institutions and industrial firms involved. It is not the task of the banks to solve industrial problems, just as it is not the task of the Banca d'Italia to implement an industrial policy, but the banks do have a duty to encourage the solution of these problems and help define their financial aspects, just as the central bank is under an obligation to promote such action and, while leaving individual bankers to answer for their own decisions, ensure that the extra burden it will place on the banks does not exceed the necessary bounds of prudence.

During the last twelve months the persistence and widening of the crisis in a number of sectors, the failure to revise investment plans and introduce measures that have long been recognized as necessary to reduce the rigidity of the labour force, as well as delay in drafting directives for industrial conversion have so aggravated the crises in a number of large companies and industrial groups that corrective measures of a general nature can no longer be usefully applied.

In the absence of more appropriate legislation, the employees of companies in difficulty are protected in the only way current regulations permit — by injecting credit to keep the companies alive even though in their present state they are incapable of showing a profit. The deterioration in the industrial sector has now clearly shown, however, that the objective of social welfare cannot be pursued indefinitely at the expense of efficiency and that the economy must regain its capacity for renewal, leaving the economic organization of human and material resources to companies and defending the sources of workers' incomes by other means.

For this purpose it would be useful if institutions were also introduced in Italy that allowed a distinction to be made between the status of workers as wage earners and as company employees. Suitably managed and controlled, such institutions could engage workers whose contract with their original employer had been terminated, undertake their retraining and even guarantee them a large proportion of their wages until they were offered a new job.

Interventions by the community which ensure the survival of companies and aim at restoring the health of the country's enterprises are justified if the losses were originally caused by an excessive burden of social charges or if the cost to the community in terms of the destruction of material and intangible assets in the event of bankruptcy is considered to be greater than that of a rescue operation. While workers who were not re-engaged by the rehabilitated companies should be protected by the means described above, on the financial front there might be a need for exceptional measures affecting oustanding debt. If it were decided, because of a public interest in the survival of such firms, to transfer to the community part of the losses which would otherwise be borne entirely by the creditors, the measures could consist in a revision of the terms under which recent investments were financed, such as eligibility for some of the facilities provided under the law on industrial conversion, rescheduling of loan redemptions and reductions in the interest on outstanding bank credit. As these interventions are true industrial rescue operations, they will need to be rigorously assessed and supervised by the authorities case by case.

Last year we outlined possible procedures for financial restructuring and expressed concern about the consequences of the compulsory funding of bank loans, mentioning in particular a deterioration in the relations between banks and firms, a weakening of the banks themselves and a reduction in the sense of managerial responsibility on both sides. Recent experience with the funding of the debts of public bodies has confirmed this view and strengthened our conviction that, despite the difference in circumstances, the damage which would result from a funding of private debts can only be limited by observing the principles which we said last year should underlie normal measures of financial restructuring: restoration of firms to genuine financial and productive health, a fair sharing of costs among the parties involved, transparency of operations and a clear assignment of responsibilities.

Monetary and credit developments

Whereas in 1976 the foreign exchange crisis had developed at such a harrowing pace that systematic, wide-ranging measures were impossible on the monetary front, in 1977 the trend was generally more even; although the market's freedom of action and responsibility were not fully restored, the system of controls was reduced in number and, in the second half of the year, in severity and was also redefined in clearer terms.

The abolition of the deposit and special tax on purchases of foreign currency was shielded by the double line of defence afforded by more active and flexible open market intervention to control the monetary base and an extension of the ceiling on bank lending until March 1978, which exerted its greatest restrictive effect in the second quarter of 1977. During that period, when developments on the foreign exchange front were taking a more favourable turn and the first signs of a slowdown in output and prices were appearing, the authorities' interventions were already encouraging a fall in short-term interest rates; this tendency received confirmation and fresh impetus in the first half of June from the two point reduction in the official discount rate, which was decided as soon as statistics on the latest trends of production and prices became available.

Hence the monetary authorities could subsequently concern themselves not only with careful control of immediate monetary and foreign exchange developments, but also with easing the restrictions and adjusting financial flows. Also in June, the first issue was made of 2-year Treasury credit certificates and the security investment requirement was renewed at a level that would absorb, in the second half of the year, a smaller percentage of new deposits than the banking system had on average invested in securities before it had been introduced. More important, a policy of intervention on the money and bond markets was pursued that would hasten the return to a structure of yields increasing with the maturity of the securities. This process was completed at the end of the summer by adjusting the discount rate a second time and further reducing Treasury bill rates, while intervention sales were made on the bond market to help maintain the new yield structure.

Until September the main aggregates relating to credit and public finance grew at rates that were more or less in line with those agreed with international organizations. In the fourth quarter, however, the Treasury borrowing requirement exceeded the agreed limits by a large amount, drawing total domestic credit with it. At the same time the disequilibrium which would afflict the public finances in 1978 was beginning to take clearer shape. In November, therefore, it seemed prudent to halt the fall in money market rates, although the decreases that had already occurred still had enough force to induce the banks to lower their prime rates further in December.

The overall picture for the year that ended in March 1978 is therefore that of an economy that has progressed further than expected towards the desired result of restoring external balance and the bitter one of a decline in output, in spite of the fact that the public sector failed to fulfil its commitment to reduce its financial imbalance. When in the autumn the economy began to veer to either side of the set course in this way, it seemed wise to do nothing that would strengthen this tendency, as would have occurred had action been taken to reduce total domestic credit to the agreed limit. Economic policy is formulated within a framework of instruments, intermediate targets and final goals, the quantitative relations between which are not accurately known. If in the course of the cycle fresh occurrences or unexpectedly strong reactions cause these relations to deviate from the magnitudes observed in the past, it must be possible to revise the intermediate targets, while taking care not to induce violent disturbances in the market.

Within this set of functional relationships, the flow of total domestic credit during the year to the end of March rose to 39,000 billion lire, exceeding by 9,000 billion the figure agreed with the International Monetary Fund. The excess was entirely due to the increase in the Treasury deficit and appears, on the basis of the quarterly targets, to have occurred mostly in the second half of the period. Loans granted to the economy by the credit system increased by 14,500 billion lire during the twelve months, almost the same as the amount implied in the figure for total domestic credit given in the Letter of Intent. This result was due in part to the conversion into lire of foreign currency bank loans for which the ceiling on lending left room at the end of 1977 and the beginning of 1978. If the expansion in total domestic credit was to be prevented from exceeding the limit on account of the increase in the Treasury deficit, the growth in loans would have had to be held down to less than half that amount. Apart from being technically difficult, this adjustment would have had to be made within the span of a few months and it would have had a disastrous effect on the equilibrium of both the financial intermediaries and their clients.

The authorities had entered into a commitment vis-à-vis the European Economic Community not to increase central-bank lending to the Treasury by more than 4,000 billion lire. Owing to large market sales of Treasury bills, credit of this kind, which had increased by 9,000 billion lire in 1976, actually decreased by nearly 5,000 billion lire in 1977, even though the Treasury's borrowing requirement was larger than the year before. This reversal of a ten-year trend could be achieved because of the liquidity created by the inflow of foreign currency and the abolition of the deposit on purchases of foreign exchange. It also indicates, however, that the creation of monetary base via the Treasury does not express the full inflationary potential of the imbalance in the public finances, especially over the short term and when bank lending is subject to a ceiling.

Although for most of 1977 the measures taken neutralized the effects on money creation deriving first from the increase in fund-raising abroad by the banks and later from the larger public deficit, the authorities again seem to be confronted with developments that may be beyond their control. Provisional data indicate that in the six months to the end of March 1978 the Treasury cash requirement (including security issues worth 5,000 billion lire for the funding of debts) totalled 20,000 billion lire and bank deposits grew at an annual rate of over 25 per cent. Unless Parliament places a firm check on expenditure, unless the State pays a sufficiently high return on savings to enable it to place its securities with the public and unless the banks themselves stop encouraging monetary expansion by offering higher yields on marginal deposits than they can earn by investing them, one cannot but view with alarm the time when the hoped-for recovery in production will gain strength and unleash these liquid balances.

The reasons for which interest rates must be kept relatively high in Italy were described on this occasion last year. Accordingly, the encouragement given to the fall in interest rates has been geared to the pace of inflation and the need to maintain an adequate differential between domestic rates and those abroad. Similarly, in its regular contacts with the banking profession and the banking associations, the Bank was able to use exchanges of information, analysis and persuasion to supplement the action it took with regard to official and money market rates in order to encourage bank rates to follow the decline in money market rates in spite of considerable difficulties.

The fall in output and a weakening of inflationary expectations, which subsequently proved to be short-lived, gave weight to the calls made in various quarters for a larger and faster decrease in the cost of funds. The advocates of such a policy point to the banks' published interest rates on loans to their clients. However, ordinary bank interest rates, which are equal to or higher than prime rates, are charged on only a fraction of total lending. Besides new bank loans in domestic currency amounting to 7,700 billion lire at an average interest rate of 19.5 per cent, foreign currency loans to the value of 3,500 billion lire were granted outside the ceiling last year at an average rate of under 9 per cent. The interest on the total outstanding loans of the entire credit system may be estimated to have averaged 14.8 per cent last year, which is lower than the increase in all the price indices. As long as this difference remains, interest payments will in practice be repayments of principal.

This comparison suggests that the roots of the malaise afflicting the productive sector should be sought elsewhere, but this does not alter the fact that those lamenting the shortage and cost of credit available for production and investment are giving voice to their refusal, which we share, to accept a situation where the productive sector of the economy is permanently hemmed in by restrictions which, in the interests of each and everyone, should be used only in brief economic and foreign exchange emergencies.

Not until the pace of inflation has been reduced appreciably by means of effective action against the root causes can monetary policy be oriented towards encouraging the growth of the productive sectors and interest rates settle at levels even nominally in line with those prevailing in other industrial countries.

Estimates given in the Treasury Minister's quarterly report to Parliament in March of this year put total domestic credit expansion in 1978 at 38,000 billion lire (with a margin of error of 2,000 billion), which is compatible with growth of between 2 and 2.5 per cent in gross domestic product; this corresponds to a 4-5 per cent increase in industrial production coupled with a current-account balance-of-payments surplus equal to 1 per cent of gross domestic product and an 11-12 per cent rise in prices during the year. It was already apparent then that it would be impossible to hold the rate of inflation below the 8 per cent limit originally established in the Letter of Intent to the IMF.

The Government programme presented to Parliament on 16th March set a target of 24,000 billion lire for the deficit of the enlarged public sector and allocated 16,000 billion lire to the productive sector.

The figure for the deficit does not include the increases in the endowment funds of public corporations and special credit institutions or allocations for the settlement of outstanding debt. If these amounts are taken into account, the borrowing requirement of the enlarged public sector comes to 28,000 billion lire.

More recent estimates, based on data contained in the latest quarterly report of the Treasury Minister and including the cost of continuing to transfer part of the employers' social security contributions to the State, put the public sector's foreseeable borrowing requirement at around 35,000 billion lire. This figure makes no allowance for the effects, small though they be, that the measures approved at the most recent meeting of the Council of Ministers will have on the deficit.

The relation between the performance of the external accounts and prices on the one hand and the liquidity of the economy on the other is erratic and difficult to predict: when liquidity exceeds equilibrium values, its effects may initially be minor but they may suddenly gather momentum as a result of either domestic or external disturbances.

If the realignment of our rate of inflation with those of the major industrial countries, and especially the countries of the Community, is not to be postponed to the distant future, action must be taken from the second half of this year onwards to reduce the public-sector deficit to the limit of 24,000 billion lire mentioned earlier, which has been widely accepted as the target for 1978.

The management of credit and interest rates will be directed towards preventing a further expansion in the liquidity of the economy, in accordance with the objectives of the budgetary policy outlined above.

The financial markets

Control of the monetary base is now exercised mainly through the Treasury bill market, which has expanded partly as a result of the more flexible criteria for intervention described in last year's Report. The Banca d'Italia was active in the market as a seller but dealt only in large amounts; the resale of Treasury bills to the general public was undertaken by other operators in the market, as illustrated by the fact that the banks, and especially the large ones, reduced their holdings as a proportion of the total outstanding and accounted for a smaller share of the volume of sales than in the past.

The development of the money market is, however, far from complete and requires, in addition to action by the Bank, a lead to be given by the operators and institutions that participate or are otherwise involved in its operation. An essential prerequisite is that an increasing number of entities, not only credit institutions but also firms, households and public bodies, practice careful financial management, showing themselves loath to leave liquid assets idle and quick to grasp profitable new investment opportunities. Although the money market intermediaries are making a valuable contribution towards the achievement of this end by providing information and stimulus, this prerequisite also depends on, and in turn determines, other factors: the transparency of the market, the transferability of securities and their variety.

First of all, therefore, the system of trading must evolve to the point where prices and yields representative of the deals concluded are quoted daily and communicated to the general public. This will lead to that market unity which can only be achieved if there is a limited number of specialized intermediaries competing among themselves but united in their common concern for the smooth operation of the market. Physical transfers, which in the case of bearer securities involve considerable risk and high costs, will become unnecessary when the procedure that the Bank is developing for transferring the ownership of bills by means of book entries is implemented; moreover, this procedure will not involve the circulation of representative certificates less acceptable to both investors and the authorities. Variety of instruments, finally, means allowing issues to be made by operators other than the Treasury, such as leading enterprises and banks. The Bank has urged that the fiscal impediments to such a development be removed, and it is to be hoped that this will be done in the near future.

It is doubtful, on the other hand, whether trading would be more efficient if it were centralized in the stock exchanges. These were established to create market unity and transparency in an era of slow and difficult communications, and they continue to perform a useful function with regard to the quotation and trading of stocks and shares. However, in the case of short-term paper, which is often traded in very

11

large quantities and at prices which vary from hour to hour, the financial managers of banks and large companies must be able to take immediate decisions even after the clearing houses have closed. Thus in practice the unity of this market will continue to be much better served — in Italy as in other countries with more highly developed money markets — by telephone networks between the operating departments so that decisions may be put into effect immediately; the Banca d'Italia itself has to operate in accordance with these practices.

Even if the growth in the volume of bills in circulation is less worrying than an equivalent increase in bank money, it would be a mistake to rejoice at this development since it also comprises an element of hypertrophy. Even when it is considered that both bank and non-bank balance sheets have been undergoing restructuring, the limits of balanced expansion were exceeded last year owing to deep-rooted causes such as inflation, the disorder in public finances and the intrinsic weakness of the economy.

In order to limit the cash component of total financial assets, the yield on Treasury bills was maintained for most of 1977, when interest rates were declining, at a level which forced banks to choose between the reduction in profit margins they would sustain by linking their deposit rates to Treasury bill yields and the disintermediation that would occur if they accepted a larger spread between the two rates. Since only a small proportion of deposits are invested in Treasury bills, the first course exposed them to losses. The banks therefore felt the competition for funds offered by Treasury bills; some accepted it and made profits on the sale of bills to their clients, others resisted and probably increased their share of the deposit market while reducing their gross profit margins, and yet others tried in various ways to keep the two markets separate.

The system of credit restrictions makes it possible to achieve more objectives than exclusive reliance on management of the monetary base would permit. Nonetheless, it would be unwise to claim that the use of restrictions has led to a more sophisticated and precise policy than would have been possible with indirect controls alone without also mentioning the costs they entail in the form of a reduction in market efficiency and an increase in the constraints under which the monetary authorities operate, costs which should not be considered less onerous because they are difficult to measure.

One such cost can be identified in the reduced efficiency of the financial intermediaries' allocation of resources caused by the abrupt changes of course made necessary by restrictions. Others stem from the forced transfer of incomes resulting from the level of interest rates. In particular, the financing of the State at reduced interest rates, to which the ceiling on bank lending has contributed, represents nothing less than a form of reverse subsidized credit which does not have the merit of being founded either on an established body of economic doctrine or on the expressed will of the people: in 1977 the Treasury bill rate was on average 3.7 percentage points below prime rate, compared with a difference of 1.4 percentage points in 1976.

Nor should it be overlooked that the longer restrictions remain in force, the less we know about their effects. At the time they are introduced, restrictions can be considered as a deviation from a pattern of spontaneous behaviour known to the authorities and documented by statistics and economic theory, but as time passes the pattern becomes indecipherable. The latest observations of the original pattern date back to an increasingly distant and different past, so that the repercussions of a sudden removal of restrictions become unpredictable. In these circumstances renewal may therefore appear to be the safest course, and a return to spontaneous behaviour a leap into the unknown.

The greatest cost, however, stems from the creation and maintenance of a situation in which an increasingly large proportion of savings is allocated for uses and granted on terms over which the public has no say, either directly or indirectly, as it would if the financial institutions to which it entrusts its money were free to take their own decisions. Having ceased to generate savings itself, the State has become progressively less able to attract those of others directly through the issue of securities that households feel provide sufficient protection of their future spending power and has eventually preferred to bring pressure to bear on the banks, debasing their role to that of mere money gatherers on behalf of others.

Years of intensive anti-cyclical monetary management and the use of credit policy to pursue industrial, sectoral and regional policies, which in many cases have not even generated as large a volume of resources as they absorbed, have made the credit system cumbersome and inflexible. While the instability of the financial markets at a time of inflation has increasingly led households to seek protection in the certain value of bank deposits, the banks have been slow to appreciate that the public has been passing them not only its savings but also the evils and risks inherent in the distorted allocation thereof, and have often failed to see the snare hidden in employing a growing proportion of their borrowed funds to grant loans that are clearly illiquid, whatever their formal title.

Should the road ahead continue to lead in this direction, the financial intermediaries will join the list of loss-making industries in need of support and assistance. If, on the other hand, an attempt is made to achieve full employment, regional balance and price stability by means of more fundamental measures directed against the true causes of the present situation, as there are grounds for hoping, then attention can be turned to the credit system, not in order to despoil it of hidden treasures, which it does not possess, but to restore the balance of its asset structure and give it back responsibility for its operations, without which it would be of little service to a rehabilitated economy. The Government has proposed a three-year programme of such fundamental measures; the return to a more balanced financial structure will also take a few years. Many opinions have been heard in the debate on this question in recent months, and the contribution made by the members of the banking community has been most valuable.

The objectives for which there is now a broad consensus and which the Bank also believes must be pursued can be summarized as follows: both the qualitative transformation of savings by the credit institutions and the multiplicity of credit instruments springing from every lira saved must be reduced to more acceptable levels than have prevailed in the last few years.

If an industrial plant with a long working life producing goods from raw materials with highly volatile prices is ultimately financed by a bank sight deposit or by a short-term foreign currency loan, the thread linking the savings to the investment is too taut and tenuous to withstand the snatch exerted by a financial, commercial or foreign exchange disturbance. On the other hand, it is true that the lengthening of the credit chain has caused an expansion in the role of the banks in the financial sector, but as far as the medium-term segment of the market is concerned their activity has been in addition to rather than in place of that of the special credit institutions, since the banks have invested in the bonds that the public no longer wants. At present the system is introverted, so to speak, and could rapidly provide a considerable quantity of funds without the need for additional monetary creation if the public resumed large-scale purchases of bonds, which would be desirable.

The credit restrictions at present in force cannot all be removed suddenly, but will have to be adjusted to facilitate the return to a situation in which the public's financial assets are less liquid, the State, the special credit institutions and enterprises are better able to draw directly on savings and the characteristics of financial instruments more closely reflect those of real investments.

In view of these considerations it does not appear that an overhaul of the restrictions in force can begin with removal of the ceiling on bank lending. This and the power to authorize bond issues constitute the means of curbing the potential creation of credit inherent in double intermediation and the large volume of Treasury bills held by the banking system. The ceiling will thus have to be renewed, but it could become less onerous and would discriminate less against the private sector if the public sector's demands on savings were to moderate.

It is, instead, in the bond market that controls could be changed or relaxed. On the supply side loans with increasing repayments of principal and yields linked directly or indirectly to prices could make it easier for some issuers to raise funds. The Bank has frequently pointed out the advantage of greater recourse to such loans by operators who by their very nature are influenced by the real cost of borrowed funds in reaching their expenditure decisions, and has made specific proposals of its own in this connection. Such loans could be used to finance not only house-building but also public utilities and large industrial companies that raise funds directly in the market. The importance that a larger volume of bond investment by the public has for sound financial balance might lead the Bank to orient issue authorizations towards encouraging the supply of securities of this type. On the demand side the return to a more normal yield curve may make it possible to rely less exclusively on bank investment and, therefore, to mitigate at least some of the distortions induced in recent years by the differing strength of the links between special credit institutions and banks.

On the other hand, the Bank is concerned at the increase in the taxation of interest on bank deposits and the rising tide of tax proposals aimed against them, heedless of the true economic nature of the tax base and of the fact that interest is already more heavily taxed in Italy than in the other major EEC countries. As long as the average yield on financial assets is below the rate of increase in prices, as has been the case practically throughout the seventies, the interest received by savers cannot properly be called income since it is rather a contribution, albeit inadequate, towards restoring the value of the principal. Those who regard such interest payments as an easy source of fiscal revenue or an obstacle to the reduction in the cost of credit for companies should consider that every increase in the rate of withholding tax has the effect of raising bank lending rates.

It has also been proposed that reserve requirements be amended so that they could be used to achieve specific objectives, for example by making the interest paid on compulsory reserves the channel whereby the Treasury would assume part of the burden of rescheduling bank loans. Three years ago this instrument was freed of the many encumbrances that had been added with the intention of pursuing selective aims but had gradually impeded its primary function of regulating liquidity. It is advisable that it continue to be reserved for this its proper task and that any changes made should be to promote general objectives in the search for better balance in financial flows.

The Bank is also unwilling to use the system of restrictions in order to regulate the shares of individual banks in the various financial markets. The Bank continues to consider, as it has stated previously, that the freezing of assets as a result of the ceiling on bank lending is one of the most serious distortions produced by this instrument. Similarly, on the liabilities side stability of market shares cannot be pursued as an objective in itself, particularly at a time when inflation has doubled the value of bank balance sheets in only a few years and when the geographical and sectoral redistribution of income is so rapid and on such a large scale that in its turn it alters the relative positions of the banks.

The greater part of the adjustment needed to achieve a more balanced financial structure will, however, depend on actions and events which lie outside the Bank's own field of operations. First among these is the banking community's ability to regulate itself. A correct perception of the boundary between the area of common interest and that of competition is an indispensable condition for more stable equilibrium in the credit sector. A reduction in the transformation of savings and in the number of bank balance sheets through which it passes are both objectives in which all credit institutions have a common interest. No external authority can help them to achieve these aims with the gradualness and respect for the fundamental requirements of the sector which they themselves can determine through behaviour based on mutual co-operation.

Problems facing the credit system and guidelines for supervision

In response to the need to modify the geographical structure of the banking system to meet the demand for banking services, a programme for the opening of new bank branches, based on guidelines approved by the Interministerial Committee for Credit and Saving, has been drawn up and recently put into effect.

A more sustained effort has been required to formulate, review and apply criteria that would reconcile the task of supervision with the demands of the present economic situation, which is still being influenced by unsolved structural problems.

In order to avoid the risk that supervision of the banking system will degenerate into a purely bureaucratic formality, we must continue by trial and error to seek ways that will lead to economic growth through the encouragement and financial support afforded to business by the credit institutions. The way is beset with difficulties and we should not underrate the danger that the failure of some projects will undermine the credibility of the credit institutions that have promoted and financed them. However, some risks must be run, not only to help the South emerge from underdevelopment and our entire economy from the present situation of inflation, stagnation and unemployment, but also to avoid an excessive erosion of the bankers' role as entrepreneurs of credit.

With these goals in mind the supervisory authorities have taken action on various fronts, reinterpreting old definitions, making more flexible use of the criteria for granting authorizations and pressing for measures to strengthen the capital base of credit intermediaries.

The need to reduce double intermediation and at the same time maintain the ability to make technical assessments of the projects to be financed has led to a functional interpretation of the principle of specialization. Under the new approach, the provision of investment finance will remain the preserve of medium and long-term credit institutions — thus maintaining some selectivity in the direction of credit flows — while it will be the duty of the banks to meet the requirement for working capital. It was therefore considered that an extension of the banks' field of operations beyond the short term, especially in the area of export promotion, would not conflict with the principles underlying Italian banking legislation. This new policy stance will improve the efficiency of the entire credit system, that is to say it will enhance its ability to satisfy the needs of borrowers.

When situations arose which made it difficult for borrowers to repay outstanding debts on time, the banks' reaction was to convert short-term loans into longer-term ones or, in the more serious cases, to take over real estate in lieu of payment. In responding to calls to remove the statutory impediments or restrictions imposed by the supervisory authorities on these operations, the Banca d'Italia has paid regard to their probable effect on the position of the bank intermediary.

In granting credit to their clients, the banks and most of the special credit institutions are obliged to observe limits that are directly related to their capital base. In many cases these ceilings have been exceeded, sometimes by a very large margin; the supervisory authorities granted the necessary advance authorization for all those projects that were considered *a priori* to be creditworthy. These decisions raised the dilemma whether to allow exceptions to the ceiling and watch the intermediary's risk concentration grow, or refuse authorization despite the serious consequences that this would have.

From the point of view of the credit intermediaries, these consequences would be negligible in the case of the large banks on account of their ability to switch from one investment to another and possibly channel any funds they could not lend into the interbank and money markets. By contrast, the effects on the small special credit institutions serving the developing areas would be extremely serious. They are only authorized to raise funds to the extent necessary to meet applications for finance; since these come from the infant local industry, which is structurally weak and highly concentrated, many would have had to be rejected by the institutions or possibly by the supervisory authorities. Not only would this have meant running the risk of condemning many medium-term credit institutions to a low level of activity, but it would also have ultimately betrayed the spirit of the legislation which established subsidized credit as the main tool for the economic development of Italy's deprived areas. While not wishing to judge the indiscriminate and sweeping use that has been made of credit subsidies, there can be no doubt that the strongest justification for this policy is the desire to compensate businessmen for the greater risk involved in setting up new plant in areas where industry is not a traditional feature and infrastructures are poorly developed.

Hence, the objectives laid down by legislation can be pursued through financial intermediaries of this type only if we accept that their risk concentration will be higher than is technically considered normal. This realization inevitably makes the supervisory authorities reluctant to see new regional medium-term credit institutions set up in southern mainland Italy, where they would take over part of the role of the institutions already granting medium and long-term credit to small firms in the area, lead a fairly languid existence and jeopardize the stability of the system. The older special credit institutions, in contrast, which have a long tradition behind them and repose on solid foundations, can spread risks over the entire country — and hence among several branches of industry and different sectors of the economy — even though they may be less able to do so than commercial banks of comparable size.

The declining quality of loans and the concentration of risks make it necessary to strengthen the capital base of the credit institutions so that it will perform adequately as a buffer against losses. In spite of the urging of the credit authorities, who have also taken concrete action by modifying some of the supervisory provisions linking the scope of banks' operations to the size of their capital base, progress is slow and most of the increase in capital has been due to valuation adjustments permitted by fiscal legislation.

It would seem easier for banks established as joint-stock companies, and especially for the co-operative banks, to raise external capital in view of their basis in the community; aware of their responsibilities at the domestic and international levels, the banks of national importance decided to increase their capital in 1978 in spite of the financial difficulties besetting their majority shareholder. Raising external capital is a far more difficult task for the public-law banks — indeed, it is prohibited in the case of savings banks. The latter have shown remarkable concern for the protection of depositors by allocating funds from their gross profits for 1977 to increase their bad-debt reserves and in some cases even by distributing a smaller proportion of their net profits to charity.

The purpose of the Government bill to increase the endowment and special reserve funds of the three public-law banks in the South is to help them overcome the adverse consequences of the measures concerning the funding of local authorities' debts and carry out their development tasks.

If supervision is to be effective it must not become set in a pattern of procedures that is impervious to changes in cyclical behaviour, market structures and the situation of intermediaries. It follows that the subject matter under the jurisdiction of the Banca d'Italia is essentially variable and technical in nature; the experience gained from past cases and the use of modern techniques of decision-making may reduce but not eliminate the area of judgement. Often the action proposed does not fall exclusively under the jurisdiction of the supervisory authorities, as the law requires them to call in other bodies exercising other powers. In this case it is the Banca d'Italia's duty to stimulate action and sometimes to propose suitable measures, but not to take decisions.

It would be alien to the tradition of the Bank to disclaim responsibility for this extensive system of interventions, a responsibility which the law has laid upon us and which the law circumscribes. It is worth recalling that the subject on which we have to deliberate is so highly technical and is so closely dependent upon the domestic and international situation that it seems very difficult indeed, short of introducing political considerations or a historical perspective, to claim that when the decision was taken a different choice was clearly preferable. It would be a simple matter to show that such *a posteriori* judgements often underrate the real difficulties which shaped the decision at the time.

Equally, an over-assiduous approach to foreign exchange controls eventually breeds the conviction among bank executives that every expression of their activity will systematically be regarded as suspect; instinctively they hold back, and gradually reduce the sphere in which they will take independent decisions. This causes credit-granting to degenerate into a bureaucratic procedure and conflicts with the widespread desire to stimulate the professional initiative and skills of bank staff, the supposed lack of which is often taken as the justification for passing harsh judgements on the banking system.

For their part, the supervisory authorities reaffirm their fundamental decision to regard the credit system as a network of firms. This decision reflects favourably on the possibility of using the discretionary powers mentioned above correctly and incisively in order to direct the full range of activities of the credit institutions towards achieving the objectives established by the competent representative bodies.

Gentlemen,

Italy is facing a great challenge, and the various groups within society now appear to be aware of the danger threatening the positions won in the far from smooth process of economic and social advance. The number of persons registered as unemployed now stands at one and a half million, a figure which rises to one million seven hundred thousand if those kept on company payrolls in excess of the labour actually required by production are included. Compared with the goal of providing the opportunity of permanent work for this army of unemployed, every other objective is but a means.

The cyclical recovery that has been signalled by various economic indicators has the same marks of impermanence displayed by similar phases of Italian economic development in the recent past. If we allow the recovery to proceed along its present course, the contribution it will be able to make to employment will be small. Before any substantial additional demand for labour has been created by the higher level of economic activity, which must first absorb the slack of underemployment, constraints will have emerged that will make it necessary to slow down the expansion. More careful demand management could help, as in the past, to reduce the amplitude of cyclical fluctuations, but it will not free us from alternating between peaks, when the rate of growth will fleetingly reach a satisfactory level, and troughs, when recession will continue to be accompanied by a high rate of inflation.

In order to loosen the grip of inflation and stagnation, concrete measures will have to be taken to reduce the public sector's deficit both on current account and overall. When this exceeds the level compatible with the economy's natural ability to provide finance, it exerts irresistible pressure on the creation of monetary base, an occurrence that is all the more distressing for the authorities concerned, who are well aware that financing with high-powered money is bound to lead to the tax levied by inflation providing the means for making good the shortfall in fiscal revenue.

There is an equally pressing need to curb the rise in wage costs by attacking the problem from both sides simultaneously — on the one hand increasing efficiency and productivity and on the other slowing down the rise in nominal wages — so as to create the conditions for a sustained process of capital accumulation.

In the short term a recovery in investment will tend to exert pressure on the current account of the balance of payments; it may even go into the red, but if at the same time real and monetary equilibrium is restored we shall be able to count on large and steady inflows of capital and prevent the external constraint from jeopardizing the lasting nature of the recovery.

The experience of the last few difficult years has increased our knowledge of this state of affairs and its causes, but knowledge is futile without the will to translate it into action: " lest it turn to [our] condemnation — the word heard and not fulfilled, ... believed and not observed ".

If we are convinced that current public expenditure has risen to an intolerable level, that it does not correspond to the needs of society and, moreover, that it may further increase in volume and deteriorate in quality, action must be taken without further delay and without half measures. A number of distortions which were not corrected in time have already compromised the public sector budget for 1978: it would be blameworthy not to prevent the deterioration that threatens to occur in 1979.

If we are convinced that the stimulation of a lasting, extensive recovery requires a policy of autonomous investment, the necessary choices must be made, the impediments arising from the slowness of administrative procedures removed and prompt action undertaken, at least in the areas where the need is most evident: energy, agriculture, the environment, public sector building, and housing. There must be no shortage of credit for such projects.

If we are convinced that the rehabilitation and expansion of the country's productive base presuppose not only the availability of resources for investment but also a clear indication of the general framework and detailed regulations governing the contribution of the public sector, the public administration must offer businessmen certainty, support and guidance through active and co-ordinated use of the instruments at its disposal: authorizations, prices, public utility charges, supply contracts and incentives.

If we are convinced that an increase in employment in a sound monetary environment can be achieved only if conditions are created in which the use of resources is profitable and the expected rate of return stable, a policy regarding the cost and mobility of labour linked to precise objectives for investment and employment must be formulated through negotiation of a social contract. Moreover, if we have succeeded in demonstrating the harm done to labour itself by wage schemes which fuel the wage/price spiral, then they must be modified.

" It would be a tragic mistake if the representatives of labour did not do everything in their power to break this spiral. Indexation gives the transitory illusion that the real value of wages can be defended without regard for the change in their nominal value. In fact, wage indexation not only weakens the already thin line of defenders guarding the currency but, by giving a further turn to the spiral, reduces workers' purchasing power during the quarter at a rate which increases with the rate of monetary depreciation. It takes from them, as holders of monetary assets, a part of the purchasing power which they have not immediately spent. When the exchange rate falls in advance of expected price increases, it causes domestic assets to be sold at bargain prices, which has an effect on national income similar to that of higher import prices ".

By assenting to changes in the schemes that they have adopted as a means for their own defence but which turn against them even in the short term and more strongly in the medium term, " workers, who justly aspire to a greater say in deciding the country's economic destiny, would be acting in the general interest which, in the final analysis, coincides with their own with regard to the purchasing power of wages, employment and the distribution of national income ".

These considerations are not new; they are taken from a letter addressed to the Secretary General of the largest trade union confederation on 5th May 1976, the day on which the price of the dollar rose to 916 lire.

During the four hectic months leading up to that day Aldo Moro, then Prime Minister, had followed and supported the action of the Bank with attention, sympathy and confidence.

Meeting at Villa Madama in the evening of the 5th, the Government decided to introduce various measures limiting the freedom to effect foreign payments in order to halt the fall in the exchange rate. These included a deposit on imports, a reduction in the length of time foreign currency could be held on account and the requirement to finance export credit in foreign currency.

Sig. Moro, who was presiding over the meeting, remarked during the discussion that to embark upon foreign trade restrictions, as the emergency demanded, was " tantamount to withdrawing from Europe ".

The analysis presented in this Report is intended as a contribution to the formulation of an economic policy which, by bringing us closer to achieving the objectives of growth and monetary stability, will serve to maintain our country, as one among equals, in the community of civilized nations.

To reflect more deeply upon what this requires of us and to make up our minds accordingly will be neither the least effective nor the least appropriate manner of reviving within ourselves the voice that has been silenced, of redeeming the wrong that has been committed.