BANCA D'ITALIA

ABRIDGED VERSION OF THE

REPORT

FOR THE YEAR

1977

PRESENTED BY THE GOVERNOR TO THE

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1978

ROME
PRINTING OFFICE OF THE BANCA D'ITALIA
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1977 closed with a growth rate for the gross product of the OECD area (3.5 per cent) that was lower than that of the previous year (5.2 per cent), than the projections made by international organizations and, above all, than the minimum rate (around 4.5 per cent) considered necessary to avoid a further increase in the unemployment rate. After a marked slowdown in 1975 and 1976, the average increase in prices was slightly over that of the previous year, even though some countries added to their successes in curbing inflation. The difficulties facing policy-makers seeking to reconcile conflicting targets were sharpened by the persistence, alongside the global deficit vis-à-vis the OPEC countries, of balance-of-payments disequilibria within the OECD itself.

The support to the growth of aggregate demand provided by inventory building, which was substantial in 1976, practically dried up as expected. The national budgets maintained, chiefly through an increase in taxation net of transfers, the essentially restrictive course initiated after the acute phase of the recession had been overcome, most of the effects of which were already apparent in 1976. The growth of world trade was weak and lower than forecast. More importantly, there was no recovery of private investment such as to compensate the curb on that by the public sector and promote a sustained and regular expansion of demand.

One of the negative results of the year was the slack performance of capital accumulation, partly due to the delay in adjusting the stock of capital to the structural changes which relative prices of goods and factors have undergone in the seventies and which represent one of the determinants of the present crisis. In addition to the persistence, in an oligopolistic framework, of margins of unutilized productive capacity that are probably still fairly substantial, investment also seems to be handicapped by expectations of only a small growth of demand and by risk factors. Pessimistic expectations do not depend only on the

Table 1

ECONOMIC INDICATORS IN THE EEC AND IN OTHER INDUSTRIAL COUNTRIES

(percentage changes)

Countries	Years	Demand (1)				Supply (1)		Implicit GNP deflator	Manufacturing industry			Unemployment as a % of the labour force
		Domestic			Foreign							
		private consumption	public consumption	gross fixed investment	exports of goods and services	Imports of goods and services	Gross national product		Production	Earnings per unit of output	Wholesale prices	
Western Germany	1976	3.6	2.4	5.0	11.1	10.6	5.7	3.2	7.8	−1.4	3.9	4.6
	1977	3.0	1.5	2.8	4.3	4.3	2.5	3.5	2.7	2.9	2.6	4.5
France	1976	4.9	4.7	4.5	9.4	19.5	5.2	9.6	9.6	3.7	7.4	4.3
	1977	2.5	4.0	−0.6	6.3	1.0	2.9	9.4	1.0	7.5	5.5	4.9
United Kingdom .	1976	0.4	2.4	−3.4	7.3	3.8	2.0	15.2	1.0	12.2	16.4	5.3
	1977	−1.0	−0.2	−7.5	6.5	4.5	−0.1	14.4	1.9	10.8	20.2	5.8
Italy	1976	3.4	1.8	1.9	13.7	14.9	5.7	18.3	12.4	10.6	21.6	....
	1977	2.1	2.3	0.1	5.8	−1.0	1.7	18.3	0.9	17.4	18.1	7.2
Netherlands	1976	2.7	4.3	−1.9	10.5	10.9	4.4	8.6	5.4	2.5	7.5	4.4
	1977	3.5	2.4	9.9	−2.4	1.9	2.3	6.8	2.7	6.0	5.4	4.3
Belgium	1976	3.3	3.3	−0.1	8.0	10.7	3.0	8.7	9.2	2.8	3.8	6.8
	1977	3.0	2.6	−1.0	3.9	3.1	2.4	7.2	1.4	5.0	3.2	7.8
Denmark	1976	6.3	3.0	16.3	2.6	16.8	4.8	9.1	11.8	4.8	8.0	4.7
	1977	−0.2	2.3	−3.7	3.9	−1.3	0.9	9.5	0.9	6.5	7.6	5.9
Ireland	1976	2.8	2.0	4.4	8.4	15.4	3.2	18.0	10.4	10.7	14.7	9.8
	1977	4.5	2.0	9.0	13.7	11.4	5.6	13.4	6.1	8.0	17.1	9.7
Luxembourg . . .	1976	3.0	2.2	−4.2	3.2	0.2	2.8	6.1	6.3	5.8	....	0.3
	1977	2.5	2.1	3.2	1.6	2.4	1.1	4.5	1.0	7.5	....	0.6
TOTAL FOR EEC	1976	3.5	2.8	2.9	9.7	11.6	4.8	9.1	7.5	7.6	9.6	5.0
	1977	1.9	1.7	0.9	4.3	1.8	1.9	9.3	2.3	8.8	8.8	5.4
United States . . .	1976	6.0	1.7	5.6	6.6	18.4	6.0	5.3	11.9	1.6	6.4	7.7
	1977	4.7	2.5	10.3	2.3	9.4	4.9	5.6	5.6	7.0	6.9	7.0
Japan	1976	4.4	3.8	3.6	16.8	8.0	6.0	6.4	13.6	−3.1	5.1	2.1
	1977	3.2	3.6	4.3	10.4	2.0	5.1	5.5	4.7	3.8	0.9	2.0
Canada	1976	6.1	0.9	0.8	8.9	8.2	4.9	9.5	5.0	8.4	5.1	7.1
	1977	3.2	3.2	0.1	7.6	3.6	2.8	6.8	3.9	5.6	7.5	8.1
Switzerland	1976	0.5	4.0	−10.7	10.2	12.7	−1.3	2.3	3.2	−8.0	−1.3	0.7
	1977	2.5	1.0	3.0	10.0	9.4	4.3	0.5	4.2	−2.5	−2.5	0.5

Source: National bulletins and EEC Commission. Figures for 1977 are provisional and partly estimated.
(1) Changes are calculated on values at constant prices.

extrapolation of the recent performance of economic activity; in fact, persistently high rates of inflation, or fears that they will reappear, induce governments to give priority to the objective of price stability, to be pursued in part by containing aggregate demand. Risk factors of a financial nature appear to have lost importance since, already in 1976, the structure of firms' balance sheets had returned to more healthy positions as regards liquidity, the term structure of debts and gearing ratios; by contrast, there are still grave uncertainties concerning costs, the composition of demand, and the relative prices of goods.

Private consumption also recorded a slowdown of growth in 1977, which reflects the weaker performance of households' real incomes, both gross and, more especially, net of taxation. Although the average propensity to consume with respect to disposable income recorded an increase, it was held in check by continuing uncertainty as to the future behaviour of employment and prices.

The performance of economic activity was particularly unsatisfactory in the second and third quarters when industrial production stagnated or declined in many countries, with the GNP of the OECD area increasing at annual rates of under 3 per cent in the absence of exogenous stimuli to demand. The system's inability to achieve self-generating growth became fully evident at that point and some countries decided to adopt expansionary fiscal measures. Part of their positive effects were already apparent by the end of the year, in the form of a slight acceleration of growth. However, growth forecasts for the whole of 1978 are no higher than 3.5 per cent.

On the other hand, even these forecasts appear unlikely to materialize because the internal and external targets pursued by the major economies continue to be contradictory, which is the main reason why economic policies did not give adequate support to production in 1977. Whereas the United States achieved its objectives for the growth of domestic demand in real terms, Western Germany and Japan fell below their targets by respectively 2.5 and 2 percentage points. Consequently, in the last two countries, which have a structural balance-of-payments surplus, the change in the external balance on goods and services had a positive influence on demand, notwithstanding the loss of price competitiveness; this testifies to the difficulty of achieving the necessary complementarity between different instruments when pursuing independent or contrasting economic policy objectives.

Due to the slack in the growth of demand the employment situation deteriorated in the EEC and this produced, in turn, a slight rise in the global unemployment rate for the OECD area (from 5.4 per cent in 1976 to 5.5 per cent) in spite of the progress made by the United States (Table 1).

The slowdown in the growth of demand helps to explain the slight increase in the average rate of inflation after it had decreased by 2 points in 1975 and 3 points in 1976. With the rate of increase of wages stable or only slightly decreasing the modest growth of productivity resulted in a higher growth rate of unit labour costs particularly in manufacturing industry (Table 1).

On the other hand, the growth of prices was not high enough to permit a further recovery of profits beyond that achieved in 1976 thanks to heavy productivity gains. The distribution of income remained practically unchanged except in the United Kingdom, where the share of employee income, adjusted for changes in the percentage of the total labour force accounted for by this income group, decreased considerably.

Despite high levels of unemployment, the fiscal and monetary policies of the OECD countries continued to be cautious, particularly in the first half of 1977, because of the persistence of inflation and balance-of-payments disequilibria. In the United Kingdom, France, Canada and a certain number of small European countries experiments in incomes policies were undertaken and almost all countries launched job-creating schemes to alleviate unemployment, especially among young people, and its social consequences, but not always in a systematic manner and with limited results on the whole.

Trade restrictions were introduced, and even more frequently threatened by a growing number of countries, with the aim of improving their external positions and supporting employment. Finally, only slight progress was made in formulating and implementing strategies to overcome sectoral imbalances, mainly in the energy sector.

Economic policy coordination within the EEC

The performance of the EEC's economy in 1977 does not reflect any great progress towards implementing a coordinated economic policy to restore sustained and balanced growth which will allow the economic system to move towards full employment.

During the first half of the year in France, Italy and the United Kingdom the restrictive slant of monetary and budget policies caused a weakening of the impulses generated by the domestic components of demand which was not matched by an adequate expansion of the external components, imports by Germany and the Benelux countries being slow to increase. In these economies the priority assigned to stability objectives, which were largely achieved, was reflected in the cautious posture of demand policy. The outcome was a drop in the production levels of the EEC which spurred the EEC Council, from the London meeting of March 30-31 on, to request new measures for economic expansion in the nations still enjoying ample room for manoeuvre. Only at the end of the third quarter were new public spending programmes and extensive tax concessions decided in Germany and the Netherlands, and an acceleration of the growth of monetary aggregates accepted. However, these measures proved of limited effect, and were implemented too late to bring about significant changes in economic performance during 1977.

Overall, the recent experience of coordination within the EEC highlights the difficulties of following up the definition of a common economic programme, with differentiated objectives according to national situations, with truly complementary policies which, by mutually reinforcing each other, will allow all the chosen objectives to be attained. The effects of insufficiently complementary policies show up in the results achieved by the EEC economy: these reveal that in 1977 no substantial progress was made in accomplishing the objectives of consolidating the economic recovery and reducing unemployment levels whereas current account deficits and inflation rates were reduced.

Community bodies contributed towards more extensive economic and monetary cooperation with substantial intervention to channel the action of individual nations and promote new progress in economic integration and in expanding the financial mechanisms called upon to support this process. Of special importance is the Commission's initiative to relaunch the process of economic and monetary union by means of a composite and articulated programme.

The Commission's proposals appear to be dictated by the justifiable need to preserve, in the present cyclical phase, a close cohesion of the economies: they invite, however, certain remarks. Recent experience has clearly shown that any coordination of economic policy instruments is a sterile achievement unless there is a firm agreement on final targets and, more especially, on the priority to be given to different objectives and their compatibility within the EEC. On these indispensable premises it would be possible to make headway in improving present coordination procedures by means of an *ex ante* assessment both of the functional relationships between final goals and quantitative guidelines for intermediate targets and of the compatibility of these guidelines at EEC level. Since these targets are indispensable for the achievement of macro-economic goals, it would be advisable to review them during the year when they appear unsuited to their task.

Fixing intermediate targets in monetary management has so far proved an effective means of laying some foundations for greater exchange rate stability. Rates of economic growth and performances of prices, costs and balances of payments are not, at present, sufficiently convergent to permit the introduction of an exchange rate structure that is binding for all the Community currencies. However, in this perspective it would already be possible to implement some measures directed at broadening the role of the EMCF, in line with the Commission's proposals, and extending the use of the EUA to denominate reserve assets and financial instruments.

While the importance of progress in the monetary sector cannot be disregarded, the basic condition for advancing the integration process remains the implementation of an effective EEC policy for economic development. During the pre-integration phase, this policy would be expected to narrow the differences of development among areas of the EEC and, subsequently, to mitigate the effects of the changes in the geographical distribution of production and investment which economic unification implies.

Obviously a return to high growth rates would make it possible to speed up the process of economic integration while reducing the costs.

International trade, current account balances and direct investment

The rise in the volume of world trade in 1977 (under 4 per cent) was clearly beneath that of the previous year (11 per cent) and lower than the forecasts prepared by the major international organizations at the start of the year (7-8 per cent), but close to the average for the previous four years. It seems, therefore, that there is a strengthening of the downward trend of the growth rate of international trade, which averaged around 8 per cent per annum over the period 1960-1972.

The growth of unit values of international trade, expressed in dollars, was very much higher (9 per cent) than in 1976 (2 per cent), chiefly owing to the changed performance of the dollar exchange rate. The increase in these same unit values expressed in domestic currency was only slightly higher, evidence that in many countries export prices tended to rise at a lower rate than domestic ones.

The stagnation of trade volumes involved all economic areas. Specifically, the growth of imports by the developed countries dropped from 14 per cent in 1976 to barely 5 per cent in 1977.

The income elasticity of international trade has been decreasing for some years now under the influence of structural factors, such as the slackening of trade creation which followed liberalization and the growth of the services sector in the more developed economies encouraged by the crisis of the seventies. Finally it appears that the unsatisfactory development of international trade is not unrelated to the effects of what can be termed protectionist measures.

The performance of international merchandise flows, coupled with a worsening of terms of trade, were reflected in a 6 billion dollar increase in the trade deficit of the OECD area. By contrast, there was a decrease in the trade deficit of the group of non-oil developing countries and of the socialist area, while the OPEC surplus remained almost unchanged. The balances on current account recorded similar performances. The picture for 1977 closely resembles that for 1974: the OPEC current surplus is still very high and is matched by heavy deficits in all other areas, despite an incomplete utilization of resources in the industrial countries (Table 2); however, once inflation over the last three years has been taken into account, the disequilibria are in fact smaller.

Although there may appear to have been some improvement in the current positions of the industrial countries, in the sense that the United States is better able to cope with the internal and external consequences of a heavy deficit than the other countries which have recorded a deficit in past years, if the present structure persists over the long run it cannot but have negative effects on the growth of trade and on international financial stability.

Global international flows of direct investment have been affected by the general slowdown of world demand. However, these flows have received stimulus from exchange rate changes and the influence of the protectionist climate. Since the latter has raised fears of a reversal of the liberalization process, over recent years many industrial countries, and especially those with a current balance-of-payments surplus, have increased their productive capacity (as well as their distribution network) in the outlet markets where there is the risk that export flows will be hampered by trade restrictions.

The balance of payments by major economic area

The unsatisfactory rate of growth of the world economy and the cyclical phase difference between the United States and the other industrial countries had a profound effect on the balance of payments by major economic area in 1977. The most important elements were the huge deficit of the United States and the reduction in the surplus of the OPEC countries (37 billion dollars compared with 42.5 billion in 1976). This fall, besides being the result of the slackening of world growth, was also due to the exploitation of new oil fields outside the OPEC area.

In addition to a current account deficit the United States also registered a net capital outflow (15 billion dollars) which was distributed unevenly over the year with a sharp increase in the last quarter caused mainly by outflows of bank funds. The greater part of the total deficit was financed by an increase in the liabilities of the United States authorities towards the central banks of the other major industrial countries.

The total outflow of long-term capital from Western Germany and Japan amounted to 10 billion dollars compared with approximately 1 billion in 1976. These outflows, though they made a valid contribution towards restoring equilibrium in the external positions of these countries, were not sufficient to counterbalance their current account surpluses and net inflows of short-term capital, so that both their reserves and their exchange rates rose over the year.

The largest increase in reserves (15 billion dollars) occurred, however, in the United Kingdom as a result of heavy inflows of both short and long-term capital. Here again the increase in reserves was accompanied by strong upward pressure on the exchange rate.

The external disequilibria of the industrial countries other than the Group of Ten and Switzerland remained large (Table 2). These countries are still suffering heavily from the effects of the oil crisis, as can be seen from the fact that their aggregate current account deficit in 1977 (22 billion dollars) was not substantially better than the maximum value registered in 1974 and that it continued to be financed mainly through borrowing on international markets.

The external position of the non-oil developing countries showed a further improvement. Their current account deficit fell from 26 billion dollars in 1976 to 22.5 billion. Nonetheless a considerable worsening of their position is to be expected in 1978 and this is indicative of the precariousness of equilibria which depend to no small extent on the reduction in their rate of growth since 1973.

International financial markets

In 1977 credit markets, favoured by a high level of bank liquidity and by an inadequate creation of financial instruments by official international institutions, continued to intermediate a very large flow of financing on more favourable terms to borrowers. Table 2 allows an assessment of the role these markets have played in financing current account disequilibria over the last few years, during which there has been a shift in emphasis away from reserve financing of international payments imbalances towards debt financing.

The largest flows were towards the smaller OECD countries which, despite large current account deficits, registered only small reductions in their aggregate reserves in 1975 and 1976, and even managed to increase them in 1977. Italy, France and the United Kingdom taken together more than offset the effects of current account deficits on their reserves over the period 1975-1977 by having recourse

Table 2

BALANCE ON CURRENT ACCOUNT, RECOURSE TO INTERNATIONAL FINANCIAL MARKETS AND CHANGE IN OFFICIAL RESERVES

(billions of dollars)

Countries	Balance on current account A (1)		(Gross) issues of international bonds B		Flows of (gross) credits from xenobanks C (2)		Flows of (gross) deposits to xenobanks D (2)		Change in net position vis-à-vis xenobanks E=C−D		Change in gross official reserves F (3)	
	1975-76	1977	1975-76	1977	1975-76	1977	1975-76	1977	1975-76	1977	1975-76	1977
Group of Ten + Switzerland . .	2.08	−11.90	30.25	14.69	81.51	13.05	115.08	18.85	−33.57	−5.80	10.67	36.95
United States	10.22	−20.20	0.89	1.41	3.54	7.25	28.69	10.08	−25.15	−2.83	2.26	1.07
Western Germany, Japan, Switzerland, Netherlands	20.16	17.96	5.92	2.64	24.90	−3.78	28.43	5.55	−3.53	−9.33	9.90	13.13
Italy, France, United Kingdom	−15.33	−0.97	6.57	4.14	35.92	1.62	44.94	0.91	−9.02	0.71	−2.12	22.25
Belgium, Canada, Sweden . . .	−12.97	−8.69	16.87	6.50	17.15	7.96	13.02	2.31	4.13	5.65	0.63	0.50
Other OECD countries	−34.60	−22.25	7.63	6.11	19.09	9.26	3.51	2.53	15.58	6.73	−2.52	1.34
Total for OECD	**−32.52**	**−34.15**	**37.88**	**20.08**	**100.60**	**22.31**	**118.59**	**21.38**	**−17.99**	**0.93**	**8.15**	**38.29**
OPEC	**73.00**	**37.00**	**0.25**	**0.52**	**9.80**	**7.80**	**12.40**	**8.90**	**−2.60**	**−1.10**	**18.24**	**9.48**
NODC	**−66.25**	**−22.50**	**2.32**	**2.44**	**17.90**	**5.60**	**12.80**	**8.20**	**5.10**	**−2.60**	**10.39**	**9.72**
Centrally-planned economies and other countries	**−31.25**	**−11.25**	**0.20**	**0.21**	**21.87**	**−5.53**	**3.60**	**−1.48**	**18.27**	**−4.05**	**0.90**	**0.06**

Sources: OECD, BIS, IMF and *Euromoney*.

(1) Figures for 1977 are estimated. — (2) Figures for flows of credits and deposits with xenobanks by OPEC countries and NODC have been calculated only for 1976 and 1977 since the appropriate statistics for 1975 are not available. For all countries data for 1977 refer only to the first 9 months of the year. — (3) The figures under this item reflect the different valuations given to gold reserves by the individual countries.

to international financial markets (the data for the United Kingdom should be interpreted taking account of London's role as a centre of international financial intermediation). For the developing countries, instead, the main sources of financing were aid, official bilateral transfers and direct investment.

The lower rate of growth of international financial flows in 1977 compared with 1976 can be explained mainly in terms of demand. In the first place, the growth of world economic activity and trade slowed down; in the second place, the smaller surplus of the OPEC countries and the larger deficit of the United States caused a reduction in the current account disequilibria of the other countries.

The OPEC countries partly shifted the distribution of their financial surpluses towards the pound sterling and the strong currencies while reducing new investment in the United States. Furthermore, the high-absorbing OPEC countries considerably increased their medium-term borrowing on international financial markets.

More generally, one of the main features of 1977 was the notable contribution of financial flows which, despite some signs of tension, enabled external objectives to be achieved without excessive internal real costs.

Exchange rates

The progressive deterioration of the United States current account and the further improvement of those of Japan and Western Germany in 1977 set the stage for large changes in exchange rates. In fact, after a period of relative calm during the first nine months of the year, the exchange rates of the major currencies came under pressure during the last quarter of 1977 and the early part of 1978 with speculative capital movements fuelling the process.

The Swiss franc, the Japanese yen and the deutschemark all appreciated considerably against the dollar (by 31, 26 and 18 per cent respectively), while the effective exchange rate of the dollar fell by nearly 8 per cent between January 1977 and March 1978. The greater part of these changes took place in the last six months of the above period. Also worthy of note is the sharp recovery of sterling, which rose over the same period both against the dollar and in effective exchange rate terms (5 per cent), thereby offsetting a part of the 1975-1976 depreciation.

A more meaningful indication of the changes in competitiveness of the various countries is provided by their real exchange rates which take account of changes in both effective exchange rates and relative rates of inflation. From this point of view the largest change was that of sterling, the real exchange rate of which rose by 14 per cent, with a corresponding loss of competitiveness, since inflation continued at a higher rate in the United Kingdom than the average for all industrial countries. The 1977 average real rate of exchange thus returned to the level of 1975 and above that of 1974. The Japanese yen also appreciated considerably in real terms (10 per cent), and this increase together with that of 1976 (5 per cent) brought the yen back to its level at the beginning of 1974. The appreciation of the deutschemark was more modest (7 per cent), but when added to the 1976 appreciation brought the real exchange rate close to the record level of the third quarter of 1973. Among the currencies considered, the one to decline the most in real terms was the U.S. dollar which fell by 6 per cent to a level close to the 1974 average. These changes in real exchange rates were in line with the current account balances of the various countries.

For the whole of 1977 the relative stability of the first nine months outweighed the disturbances of the last quarter and the changes in exchange rates took place in less turbulent conditions than in 1976. The average monthly variability of the exchange rates of the eleven major industrial countries declined, thereby confirming a trend which has been almost constantly present since 1973 and to which attention was drawn in the last two Reports. The great instability of the first years of floating rates may, therefore, have been mainly caused by the need to correct the disequilibria accumulated over the preceding years, the novelty of the regime to which operators had to become accustomed, and the marked variability of underlying economic trends, rather than by features inherent in the floating rate regime itself. The reduction in the average variability since 1973 does, nonetheless, hide large fluctuations at the level of individual countries.

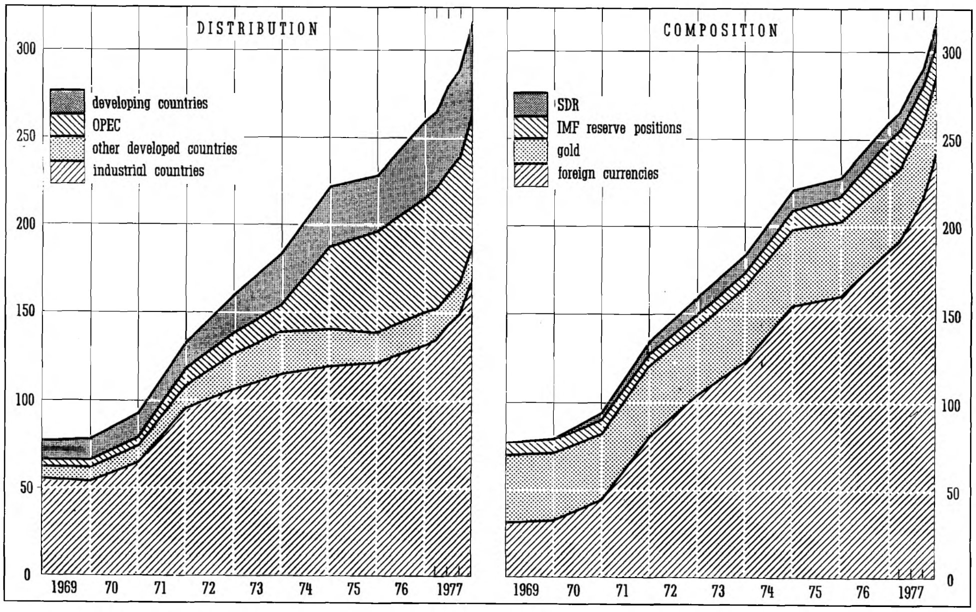
Monetary authorities have made massive interventions in the highly turbulent conditions obtaining in exchange markets since September 1977, both so as to halt the decline of the dollar and so as to reduce its short-term fluctuations. It should also be noted that at the end of October 1977 the U.K. authorities renounced their efforts to contain the appreciation of sterling so as not to compromise the achievement of monetary targets. Japan and Western Germany intervened heavily, especially during the last quarter of 1977 and the first quarter of 1978.

Changes in international reserves

Official international liquidity — defined as the total of gold, special drawing rights (SDRs), reserve positions in the IMF, and monetary authorities' holdings of convertible currencies — amounted to 317 billion dollars at the end of 1977. The increase over the year was equal to 23 per cent compared with an increase in the value of world trade of 13 per cent (Chart 1).

The evolution of gross international liquidity continues to be influenced by the pattern of deficit countries' financing of international payments imbalances. In fact they have preferred borrowing to reducing their official reserves which are increasingly taken as a measure of international creditworthiness.

Chart 1



Official international liquidity
(billions of dollars)

Source: IMF

It is often argued that such a system of international liquidity creation, whereby the supply of reserves, through the intermediation of financial markets, is largely determined by demand, contains the seeds of instability. Countries can, in fact, be led to postpone necessary adjustment measures and maintain levels of economic activity which are incompatible with price stability. In this connection it should be remembered that the IMF has played an important rôle in granting loans conditional upon the pursuit of specific economic policies designed to eliminate the causes of external payments disequilibria. In this way the IMF has influenced the allocation of commercial banks' financing since, on more than one occasion, the actual disbursement of such funds has been made dependent upon the IMF's favourable evaluation of national economic policies.

From a more general point of view, concern about the existence of excess international liquidity does not take into account that the inflationary effects it might produce depend not only on the total amount of reserves but also on their distribution. If, as has happened recently, international liquidity tends to flow back towards a limited number of countries which are able to prevent the increase in reserves from being translated into an increase in aggregate demand (in 1977 three countries — Western Germany, Japan and Saudi Arabia — absorbed more than a quarter of newly created liquidity), the creation of international liquidity does not produce all its feared inflationary potential. Furthermore, if one considers the traditional indicators of the adequacy of international reserves one finds — despite their analytical shortcomings — that there is a shortfall rather than an excess of liquidity. In fact, the ratios of official liquid reserves to the value of imports in 1977 were lower — with the exception of oil-exporting countries — than those registered in the early seventies. Further proof of the relative inadequacy of official reserves is provided, albeit indirectly, by the increasing recourse of many countries to protectionist measures.

II. – THE ITALIAN ECONOMY

FORMATION OF INCOME AND THE PERFORMANCE OF THE ECONOMY

The economic stabilization programme

The performance of the Italian economy in 1977 largely reflected the policy of stabilization which has been followed since the end of 1976, but the course of the world economy was widely different from that forecast when the measures of economic policy were prepared.

At the beginning of the year the need to bring the rate of inflation down closer to that of the major industrial countries and to reduce foreign indebtedness limited the possibility of expanding the economy because of the high income elasticity of imports and the rigidities present in the labour market.

A start had already been made on implementing the economic policy package at the end of 1976 with fiscal and tariff measures which were intended to raise the receipts of the public sector and ENEL by 5,000 billion and, through increases in regulated prices, to correct the shifts taking place in the distribution of income from enterprises to households.

These measures were flanked by monetary and foreign exchange measures including: the ceiling on bank lending in lire, which was reintroduced in October with the aim of curbing the expansion of credit and of increasing the flow of foreign currency towards the banks; the increase in the discount rate from 12 to 15 per cent; and the temporary tax on purchases of foreign currency which was in addition to the compulsory deposit on foreign payments.

The economic policy package, with further details and undertakings, was included in the letter of intent which the Italian Government sent to the IMF in the middle of April in connection with a 500 million SDR stand-by credit, and in the recommendations of the EEC Council in connection with the medium-term financial support granted in December 1974 and the subsequent loans granted in March 1976 and May 1977 for a total of 1,500 million dollars.

The estimation of the principal aggregates of the national accounts considered in the agreements with the IMF and the EEC was based on a model of the behaviour of the Italian economy, in which it was assumed that world demand and the dollar export prices of the leading industrial countries would increase by respectively 8 and 7 per cent, and that the effective exchange rate of the lira would remain stable for a considerable period at the level of the first quarter of 1977. Finally, it was supposed that the increase in wages in 1977 would be caused mainly by the sliding scale mechanism (27 points). The following targets were set within the framework of the reference model: substantial equilibrium of the current account of the balance-of-payments in 1977, a surplus of 500 billion lire for the year March 1977-March 1978, and a reduction in the annual rate of inflation, measured in accordance with the changes in the trade-union index used for the sliding wage scale, from 22 per cent in December 1976 to 16 per cent in December 1977 and to 13 per cent in March 1978.

This implied that the volume of exports would increase by 9 per cent and that of imports by 3.5 per cent, while domestic demand would grow by between 1 and 2 per cent in real terms and gross product by between 2 and 3 per cent. The terms of trade were expected to improve by 1 percentage point and services to provide a balance-of-payments surplus similar to that of the year before.

To achieve these ends the following intermediate targets were set for economic policy: an annual limit, integrated by quarterly targets, on total domestic credit expansion of 30,600 billion lire for 1977 (EEC) and of 30,000 billion for the twelve months ending in March 1978 (IMF); a limit on the deficit of the enlarged public sector of 16,450 billion for the calendar year 1977; maximum increases in the sliding wage scale (7 points in May 1977, 6 in August 1977, 5 in November 1977, 4 in February 1978 and 4 in May 1978). The fiscalization of employers' social security contributions, already introduced by the Government and financed out of new revenues, was judged to be a suitable means of keeping down the increase in the cost of labour. The EEC also recommended that central bank financing of the Treasury should not exceed 4,000 billion lire.

The trade results achieved with world demand increasing by only 4 per cent were: a 5.8 per cent increase in exports, a 1 per cent fall in imports, and a 2 percentage point improvement in the terms of trade (Table 3). These results caused the current account of the balance of payments to show a surplus of 2,014 billion lire in 1977, and this should rise to 2,800 billion for the twelve months ending in March 1978.

Table 3

EVOLUTION OF AGGREGATE DEMAND AND SUPPLY

(percentage changes)

Items	at current prices	implicit prices	at 1970 prices		
	1977/1976	1977/1976	1977/1976	4th qtr. '76 (1)/avg. 1976	4th qtr. '77 (1)/avg. 1977
Demand:					
consumption	21.3	18.7	2.2	1.0	–0.4
private consumption	*20.5*	*18.0*	*2.1*	*1.2*	*–0.6*
gross investment	6.4	15.5	–7.9	7.0	–3.7
gross fixed investment	*19.0*	*18.9*	*0.1*	*2.2*	*–3.1*
domestic demand	17.8	17.7	0.1	2.2	–1.0
exports of goods and services	26.0	19.1	5.8	6.6	3.8
total demand	19.4	18.0	1.2	3.1	–
Supply:					
gross domestic product	20.3	18.3	1.7	2.1	–1.0
imports of goods and services	16.4	17.5	–1.0	7.6	4.8

Source: Data from the *Relazione generale sulla situazione economica del paese*. For seasonally adjusted quarterly data, ISCO-Banca d'Italia estimates have been used.

(1) Figures for the fourth quarter are on an annual basis, i.e. they are multiplied by 4.

In real terms domestic demand increased by only 0.1 per cent (1.8 per cent excluding the change in inventories) and gross domestic product by 1.7 per cent. The price index used for the sliding wage scale rose 17.7 per cent in 1977 with respect to 1976, while between December 1976 and December 1977 it rose by 13.1 per cent, and between March 1977 and March 1978 by 12.5 per cent. The sliding wage scale rose 24 points during 1977.

Until the third quarter total domestic credit expansion remained in line with the objectives set. It exceeded the limit by 3,650 billion lire in the fourth quarter and by an even larger amount in the first quarter of 1978, mainly as a result of the course of the public sector deficit.

The fact that the intermediate objectives for domestic credit expansion and the public sector deficit were not respected at the end of the year while the final objectives for prices and, above all, the balance of payments were considerably improved upon can be explained in the light of two fundamental considerations.

The first is based on the performance of total domestic credit and in particular on that of the public sector deficit. In view of the usual lags with which credit instruments produce effects on real aggregates and prices, one can consider that the total demand for the whole of 1977 was determined by the performance of credit until the third quarter which, as already pointed out, was as forecast. The excess expansion of the last quarter of 1977 and the first quarter of 1978 will, in its turn, probably affect the results of this year.

The second is rooted in the causes of the larger than forecast balance-of-payments surplus, one fifth of which was due to the larger than expected improvement in the terms of trade, about three fifths to an exceptionally large contribution from services and, in particular, tourism, and the rest to a slowing down of imports which was more than proportional with respect to exports and domestic demand.

A decline of three percentage points in the growth rate of exports corresponds to a decline of approximately one percentage point in the growth rate of gross domestic product. Given the already downward course of domestic demand and the restrictions placed on credit, the outcome was a sharp deceleration in the formation of inventories (particularly of raw materials) so that imports of goods and services contracted by 1 per cent in real terms despite an increase, albeit small, in final domestic demand and income. This contraction accentuated the positive balance-of-payments results in 1977, but there will inevitably be a fluctuation of the opposite sign in 1978 or 1979 in view of the relative stability over the medium term of the income elasticity of imports. As for the rise of the sliding wage scale, the slightly better than expected performance, besides being due to the changes made to the basket of goods upon which it is based, was also caused by the weakness of domestic demand. However this did not improve unit labour costs since the rise in productivity slowed down as a result of the larger than forecast slowdown of industrial output.

The indebtedness of the Treasury vis-à-vis the Banca d'Italia fell by 4,300 billion lire. In fact the ceiling on bank lending made it possible to place a large quantity of Treasury bills as a counterpart to the inflow of funds from abroad which was mainly in the form of bank borrowing. This, in its turn, was connected with the highly liquid situation of the international banking system and interest rate differentials. However, the total change in the monetary base over the whole year was close to that which had been forecast.

The exchange rate remained at the level of the first quarter until September as had been expected while it suffered a 4 per cent depreciation during the last quarter in connection with changes in market expectations and the diverging courses of the dollar and the main European currencies.

The improvements the process of stabilization brought must be set against the high costs it involved: a reduction in the degree of plant utilization and an increase in unemployment which mainly affected the young. This last phenomenon, which is common to other industrial countries, was more marked in Italy because of the sharper fall in output and because it is a country characterized by emigration.

Overall results and intermediate performance

The overall use of resources was only partly in the direction of the desired structural changes. The proportion of total domestic uses accounted for by exports increased, thus continuing to compensate for the worsening of the terms of trade in the wake of the energy crisis. With respect to domestic demand, instead, the shift in the use of resources from consumption to investment needed to improve the efficiency of the economy and to provide scope for absorbing unemployment, did not take place. As a result of the slowdown of domestic demand the ratio of imports to gross domestic product in real terms continued to decline.

The average increase in implicit price deflators over the year was still very large despite the fact that the rate of increase slowed down quite considerably. That for GDP at market prices was 18.3 per cent, which was the same as the year before. Since GDP grew by 1.7 per cent in real terms, the total increase at current prices was 20.3 per cent, which falls to 19.1 per cent on passing to net national product at factor cost.

Domestic income from employment increased by 21.8 per cent (22.0 per cent in 1976) as a result of a larger increase in gross earnings (25.7 per cent compared with 21.1 per cent in 1976) and a rise in employers' social security contributions which, however, was almost halved thanks to the Government taking over a part during the year.

The modest growth of productivity resulted in unit labour costs increasing by 18.9 per cent in the whole of the private sector and by 17.4 per cent in the industrial sector excluding construction.

The distribution of income shifted 1.7 percentage points in favour of income from employment leaving investment, enterprise and self-employment income with 28.4 per cent of the total, as against 30.1 per cent in 1976.

The momentum the economy had acquired at the end of 1976 carried over into the first quarter of 1977. The high levels of consumption and more especially investment demand at the end of 1976 caused output to go on expanding through January and it remained buoyant for the whole of the quarter. Investment, which was mainly in machinery and means of transport with housebuilding continuing to stagnate, peaked during the first quarter while prices continued to rise at a rate which proved to be the highest for the whole year, in part because of the increases in public utility charges introduced at the end of 1976.

The first quarter also saw the introduction of important economic policy measures regarding taxes, legislation to curb labour costs, and monetary controls. These were in addition to the October 1976 increases in indirect taxes, regulated prices and public utility tariffs.

These measures included: changes in the wage indexation scheme designed to reduce its effects on severance and retirement bonuses, and to bring the systems of total indexation present in a number of sectors into line with that of the industrial sector; the fiscalization of a part of employers' social security contributions in the industrial sector so as to contain the increase in costs induced by the record nine-point rise of the sliding wage scale in February, when the process of bringing the various values of the sliding scale point up to the highest level was also completed; and, finally, the introduction of advance payments of personal income tax and company tax to be made under the self-taxation system.

In order to regulate credit flows, compulsory investment in securities of a proportion of the increase in bank deposits was renewed for a further six months in January. At the end of March the ceiling on bank lending was extended for a year in line with the targets for total domestic credit expansion agreed with the IMF and the EEC. In fact bank lending grew particularly slowly until September, after which it accelerated.

The effect of the announcement of these fiscal measures, together with the initial impact of the payment of sliding scale wage increases for higher income groups in the form of special Treasury bonds, caused a fall in consumer demand which took both trade and industry by surprise. Despite the fact that industry had already started to adjust its production plans in February there was still an exceptionally large increase in inventories.

This excess supply in the first quarter influenced the level of output in the second. Notwithstanding a certain recovery of consumption — due mainly to the presence of foreign tourists — which went some way towards compensating the earlier negative impact, the downturn of investment, together with the need to run down the sudden and massive accumulation of inventories, caused a sharp fall in the level of productive activity. The need to reduce inventories was influenced by the limits imposed on bank credit as well as by the pre-existent problem of its cost. In addition, the prospect of a weakening of international raw material prices tended to result in purchases of imported goods being put off.

The fall in production was immediately reflected in the labour market and, though it did not immediately affect the number of persons in employment, the average number of hours worked declined for the first time for more than a year. Since wages continued to rise despite the fact that the May increase in the sliding scale was relatively small, unit costs rose very sharply.

However, this did not prevent the combination of exchange rate stability and falling international prices from producing the first signs of a moderation in the rate of inflation which was more marked for wholesale prices than for consumer prices.

The second quarter saw further increases in public utility tariffs which had already been considerably increased in March. In addition, the first effects of the restructuring of the price index used for the sliding wage scale made themselves felt. These changes had been made in February and consisted in the elimination from the basket of a number of items whose influence on the index did not correspond to their real importance.

The restriction on lending caused a further large flow of foreign currency towards the banks which made it easier to maintain the exchange rate stable. There were also signs of a turnaround in the trend of the balance of payments to which both the aforementioned fall in raw material imports and the expansion of tourism contributed.

This tendency was reinforced in the third quarter when the dependence of imports on the level of production caused them to fall further. In consequence, the trade balance moved into surplus even though exports were falling off as a consequence of the progressive slowdown in world demand.

The only component of demand to expand during the third quarter was the domestic consumption generated by foreign tourism. Residents' consumer demand remained virtually unchanged at the level of the previous quarter, while the fall in investment and the adjustment of inventories to current levels of production both continued.

With demand following this course there was a further fall in the level of production with the index of industrial output falling to more than 7 per cent below the peak reached in the first quarter. Employment and working hours both contracted with the unemployment rate rising to the highest value of the year, in part as a result of the increase in the supply of labour. There was also an increase in the payments of the Wage Equalization Fund after a period during which they had progressively declined.

In this situation economic policy, while continuing along the lines designed to produce a change in the structure of the economy and a slowdown in inflation, attempted to stimulate productive activity which appeared to have sunk to a worryingly low level. Greater awareness of the problems of supporting economic growth at the international level, especially in the form of proposals for more widespread and coordinated interventions, also contributed to this orientation.

This quarter also saw the approval of Law no. 675 regarding the creation of a “ fund for the restructuring and conversion of industry ”. The discount rate, which had already been lowered by two points in June, was lowered a further one and a half points to 11.5 per cent at the end of August. The requirement that the banks should invest in securities was renewed and the fiscalization of employers' social security contributions was extended to include several types of commercial company.

Under these recessionary conditions inflation slowed down considerably with the lowest values being recorded between June and August. This had a beneficial effect on the increases in the index of the sliding wage scale which remained below the limits foreseen in the agreements with the IMF and the EEC. Until September total domestic credit also remained exactly in line with the undertakings in these agreements, while the State sector's financing requirement, which had remained within the agreed limits until June, began to go beyond them.

By the beginning of the fourth quarter it was obvious that the objectives regarding the balance of payments and the slowdown in inflation were on their way to being achieved, the former faster than had been expected. The counterpart of these results was, however, a particularly low level of productive activity.

In order to create conditions favourable to the start of a recovery, advance self-taxation payments were put off until November and their exemption thresholds raised. As previously mentioned, the public sector deficit rose way above the forecast value in the fourth quarter, thereby also causing total domestic credit to exceed its target for the quarter.

Furthermore, it appeared likely that there would be a large increase in the enlarged public sector deficit in 1978. Preliminary corrective measures were taken at the end of the year in the form of increases in public utility charges, the extension of self-taxation to the local tax on incomes, an increase in the withholding tax on interest payments, and an additional road tax on diesel motor vehicles.

Even though there was some improvement in the international situation, the results of the fourth quarter did not show the recovery which had been expected. Investment remained virtually stationary and residents' consumption fell substantially, a phenomenon to which the slowdown in the rate of wage increases, the contraction of hours worked and the prospect of a decline in employment all contributed.

Only inventories started to rise again, albeit moderately. This inversion probably came about because enterprises considered that they were close to equilibrium with respect to finished products, and because world raw material prices started to rise again. The greater availability of credit and enterprises' increased liquidity also acted in the same direction, despite the fact that the reduction in nominal interest rates was offset by an even sharper fall in the expected rate of inflation.

According to the latest available figures, the build-up of inventories seems to have continued in the first quarter of 1978, especially in the case of intermediate and semi-finished products.

In fact the first quarter of 1978 saw industrial output expand by nearly 3 per cent compared with the last quarter of 1977, while provisional figures for imports indicate that these fell by approximately 4 per cent over the same period.

The seasonally adjusted current account balance showed a surplus of approximately 600 billion lire (whereas there had been a deficit of 400 billion in the first quarter of 1977) despite the fact that exports also declined at nearly the same rate as imports. This reduction in the volume of trade must, however, be seen bearing in mind that the level of the fourth quarter of 1977 was particularly high.

There also seem to be signs of an acceleration in the rate of price increases, especially in the case of consumer prices. The sliding wage scale rose 5 points in May instead of the 4 which had been expected and thus annulled one of the three points gained between May 1977 and February 1978.

Prospects for 1978

Despite some signs of recovery, economic performance in 1978 will be influenced by the low level of economic activity at the end of 1977, the still uncertain prospects for world demand, the lack of large new investments in the private sector, the financial crisis afflicting the State enterprises and some of the major private groups, and the apparently slow recovery of consumption and inventory demand which, however, is conducive to the maintenance of external equilibrium.

Basically the recovery will be triggered by the public sector deficit, although its size for the whole year is likely to compromise the objectives of bringing the rate of inflation into line with that forecast for other countries and achieving balance-of-payments surpluses that will permit the repayment of previously contracted loans. At the same time the quality of public spending shows no sign of an improvement allowing changes to be made in the economic structure over the medium term.

Assuming that the measures to reduce and postpone public spending and increase receipts which the Government hopes to introduce produce their effects in the second half of the year, the growth of income in 1978 will be in the region of 2-2.5 per cent, with a rate of increase during the year equal to about double that figure. The rise in consumer prices may be kept below 13 per cent for the year and it may be possible to achieve a balance-of-payments surplus of 2,000 billion lire.

In view of the wide margins of unutilized productive capacity and a distribution of income which only aggravates firms' already serious financial difficulties, investment is insufficient and the employment situation is deteriorating further. In fact, while employment in industry remains stationary, a possible increase in the services sector does not appear sufficient to absorb the rise in the working population.

In last year's Report it was stated that only by means of policies aimed at changing some of the structural features of the economic system would it be possible to avoid recurrent adjustments, particularly in the area of domestic demand.

In this context, in addition to the passing of the law on industrial conversion and to the guidelines for its implementation subsequently issued by the CIPI (Interministerial Committee for the Coordination of Industrial Policy), recent decisions include measures in the agricultural sector to bring about a substantial reduction in the food deficit — which is second in size only to the oil deficit — and to bring productivity up to the levels of the other EEC countries.

The reduction of the public deficit and the reallocation of public spending are the first necessary condition for the success of economic policy action to alter structural features. A smaller deficit will make more funds available to expand and improve the productive sector, while the channelling of a larger share of public spending towards investment is necessary if the costs of inefficient social services are to be prevented from obstructing the process of reallocating resources.

However, structural interventions take time to affect the basic characteristics of the productive system. 1978, then, is a crucial year for ensuring that the stabilization programme now under way produces lasting effects.

With world demand likely to grow only slowly, the chief danger is that destabilizing expectations will develop within Italy as a result of exchange rate fluctuations in an international context in which currencies are far from having settled down, the size of the deficit of the enlarged public sector and, finally, an increase in labour costs in the sectors most vulnerable to international competition larger than is justified by the growth of international lira prices for manufactures.

The containment of labour costs, not only on average for 1978 but especially during the " season " of contract renewals at the close of the year, is the second condition for the success of the stabilization programme. And it is on this success that we depend for a further slowdown in the rate of inflation, increased investment — by restoring profit margins so as to leave room for financing new projects — and a gain in international competitiveness. In view of the considerable openness of the economy and the existence of almost fully indexed wages in industry, it is impossible to maintain competitiveness in the long run by resorting to exchange rate changes. According to our estimates, within a year 50 per cent of a devaluation is transferred onto consumer prices and 80 per cent onto export prices, thus cancelling out the gains in competitiveness and setting off the inflationary spiral again.

Domestic demand

Consumption

The growth in consumer expenditure by resident households in 1977 was modest (1.3 per cent) and below the average for the previous three years, which includes the decline recorded in 1975. In monetary terms the increase was 19.5 per cent and in fact, on average for 1977, the growth rate of implicit prices showed no decrease from the already high rates of the two previous years (18 per cent compared with 17.8 in 1975 and 17.9 in 1976). Since personal disposable income grew at a rate of little over 20 per cent, the average propensity to consume dropped to 74.6 per cent, the lowest level since 1970 and one of the worst since the last war (Table 4).

Table 4

CONSUMPTION, DISPOSABLE INCOME AND AVERAGE PROPENSITY TO CONSUME OF HOUSEHOLDS

Items	1970	1971/1970	1972/1971	1973/1972	1974/1973	1975/1974	1976/1975	1977/1976
	(billions of lire)	*(percentage changes)*						
Final consumption:								
at current prices	36,696	*9.0*	*10.2*	*19.1*	*24.3*	*15.8*	*21.7*	*19.5*
at 1970 prices		*2.9*	*3.4*	*6.1*	*2.6*	*−1.7*	*3.2*	*1.3*
Gross disposable income:								
at current prices	46,512	*11.3*	*10.6*	*19.3*	*21.4*	*21.0*	*22.3*	*20.1*
at 1970 prices (1)		*5.1*	*3.9*	*6.2*	*0.2*	*2.8*	*3.8*	*1.7*
Average propensity to consume	78.9	*77.2*	*77.0*	*76.9*	*78.7*	*75.3*	*74.9*	*74.6*

Source: *Relazione generale sulla situazione economica del paese* and Banca d'Italia estimates.
(1) Gross disposable income has been deflated using the implicit deflator for consumption.

The evolution of consumption during the year was fitful: the small decline of the first quarter gave way to a recovery in the second and stagnation in the third, while towards the close of 1977 there was a marked decrease.

Consumer spending tended to reflect the trend of real personal disposable income with a lag of about six months, even though the economic policy measures introduced during the year had a more direct and immediate impact by altering households' expectations and behaviour. Hence the freeze on sliding scale increases for those with annual incomes above 6 million lire and the abolition of some systems of 100 per

Table 5

PUBLIC AND PRIVATE GROSS FIXED DOMESTIC INVESTMENT BY BRANCH OF ECONOMIC ACTIVITY

Type of investment	Billions of lire (at current prices)	Percentage breakdown (at 1970 prices)		Percentage changes					
				at current prices				at 1970 prices	
	1977	1976	1977	1974/1973	1975/1974	1976/1975	1977/1976	1976/1975	1977/1976
AGRICULTURE	2,662	*8.1*	*8.1*	*31.1*	*25.4*	*29.9*	*17.0*	*8.9*	–
Private enterprises	2,485	*7.4*	*7.6*	*37.8*	*33.9*	*22.5*	*19.1*	*2.8*	*1.7*
Public enterprises (1)	177	*0.7*	*0.5*	*–12.5*	*–61.0*	*285.5*	*–6.1*	*220.0*	*–18.7*
INDUSTRY	10,208	*28.5*	*28.1*	*37.3*	*–5.2*	*16.9*	*16.7*	*–1.6*	*–1.1*
Private enterprises	7,294	*18.6*	*20.1*	*50.1*	*–13.8*	*19.9*	*27.7*	*0.9*	*8.1*
Public enterprises	2,914	*9.9*	*8.0*	*14.5*	*15.0*	*11.8*	*–3.9*	*–6.0*	*–18.6*
SERVICES	9,147	*27.7*	*28.9*	*28.9*	*5.3*	*30.0*	*23.5*	*10.2*	*4.3*
Private enterprises	6,313	*18.8*	*19.9*	*33.5*	*1.0*	*35.2*	*25.8*	*14.6*	*6.3*
Public enterprises	2,834	*8.9*	*9.0*	*20.0*	*14.6*	*20.3*	*18.7*	*2.0*	*0.2*
HOUSEBUILDING	9,468	*27.3*	*26.8*	*36.3*	*5.5*	*14.7*	*18.9*	*–3.4*	*–1.8*
Private enterprises	8,618	*24.9*	*24.4*	*34.4*	*3.2*	*13.1*	*18.5*	*–4.7*	*–2.1*
Public enterprises	(2) 850	*2.4*	*2.4*	*82.6*	*44.9*	*33.7*	*23.2*	*12.8*	*1.8*
TOTAL	31,485	*91.6*	*91.9*	*34.3*	*2.8*	*20.7*	*19.3*	*2.0*	*0.4*
Private enterprises	24,710	*69.7*	*71.9*	*39.2*	*–0.6*	*21.0*	*23.0*	*2.2*	*3.3*
Public enterprises	6,775	*21.9*	*20.0*	*19.0*	*15.1*	*19.7*	*7.6*	*1.3*	*–8.7*
GENERAL GOVERNMENT	2,708	*8.4*	*8.1*	*17.9*	*21.3*	*24.4*	*15.6*	*0.7*	*–3.3*
GROSS FIXED INVESTMENT . . .	34,193	*100.0*	*100.0*	*33.1*	*4.0*	*21.0*	*19.0*	*1.9*	*0.1*
Public sector	*9,483*	*30.3*	*28.1*	*18.8*	*16.7*	*20.9*	*9.8*	*1.1*	*–7.2*

Source: *Relazione generale sulla situazione economica del paese.*
(1) Payments by the State for investment expenditure. – (2) Estimated.

cent wage indexation probably made households more careful about their spending and kept consumption down in the first half of the year. Subsequently the self-taxation system and the prepayment of taxes partly determined the downward trend of the last two quarters.

Investment

Inadequate investment activity undermined the development of aggregate demand in 1977 as in the previous two years. Fixed investment held to practically the same level as the year before (0.1 per cent increase in volume) whereas, net of depreciation, the flow was the smallest since 1970. In monetary terms, fixed investment showed a sizeable increase (19 per cent) since implicit prices (up by 18.9 per cent in 1977 against 19.5 in 1975 and 18.7 in 1976) continued, for the fifth year running, to grow at higher rates than the GDP implicit price deflator.

Fixed investment remained largely stationary because of the difference in performance between private and public enterprises: an increase for the former (up 3.3 per cent) against a heavy fall-off for the latter (down 8.7 per cent; Table 5). In the private sector the rise in investment in industry and the services sector contrasted, for the third year, with a decrease in housebuilding. Meanwhile, in the public sector, the standstill in social investment caused by the gradual drying

Table 6

INVESTMENT AND SAVING

(as a percentage of the gross domestic product at current prices)

Items	1970	1971	1972	1973	1974	1975	1976	1977
Gross investment	23.1	21.0	20.4	24.4	26.9	20.2	23.9	21.1
Net investment	14.4	12.4	11.8	15.5	17.2	9.3	13.0	10.1
Balance on current foreign transactions	1.3	1.9	1.7	−1.9	−5.0	−0.2	−1.7	1.1
Gross saving	24.4	22.9	22.1	22.5	21.9	20.0	22.2	22.2
private sector	*23.3*	*24.3*	*25.5*	*25.5*	*24.1*	*27.3*	*27.3*	*27.1*
Net saving	15.7	14.3	13.5	13.6	12.2	9.1	11.3	11.2

Source: *Relazione generale sulla situazione economica del paese.*

up of funds allocated under the laws passed in 1975 and 1976 was accompanied by a sudden fall in industrial investment (down 18.6 per cent in volume and 3.9 per cent in value) owing to the limited nature of earlier programmes and to the financial difficulties afflicting many State holding companies. Finally, direct investment by General Government decreased by 3.3 per cent.

For the first time since 1972, domestic saving was sufficient to finance gross investment (Table 6). Between 1976 and 1977 the gap between the increase in private sector saving and that in investment was so wide as to allow the massive General Government current deficit to be financed entirely from domestic resources. As a result the balance on foreign transactions turned around from deficit to surplus.

Domestic supply

Agriculture

For the second year running total agricultural production in volume terms actually decreased, albeit less sharply than in the previous year (down 0.2 per cent against 1.9 per cent in 1976; Table 7), after having experienced a slowdown in its growth rate over the first half of the decade. The structural weakness of Italy's agriculture was aggravated by particularly bad weather at critical moments (rain in autumn 1976 and frost the following spring) with the result that its value added at factor cost was barely above that of ten years ago at constant prices. Employment continued to fall (from 3,020,000 in 1976 to 2,950,000 in 1977) despite the fact that for the first time there was an increase in available manpower for agricultural activities.

It is worth noting also that there were considerable differences in production performances between the various branches and between the first and second halves of the year. Field and fodder crops — most of which are harvested in late spring — showed the worst results (down 8.7 per cent), but these were partly offset by the increase (4.7 per cent) in tree crops — mostly picked in late autumn — so that the second half of the year saw a reversal of the trend for agricultural production.

Table 7

MARKETABLE PRODUCTION AND VALUE ADDED IN AGRICULTURE

Items	Values at 1977 current prices (billions of lire)	Percentage changes over the previous year					
		value		volume		price	
		1976	1977	1976	1977	1976	1977
Marketable production	18,293	*18.7*	*17.2*	*–1.9*	*–0.2*	*21.0*	*17.4*
Field and fodder crops	5,729	*27.1*	*3.1*	*–1.6*	*–8.7*	*29.2*	*12.9*
Tree crops	4,424	*–3.9*	*36.5*	*–11.3*	*4.7*	*8.3*	*30.4*
Livestock	7,546	*26.1*	*19.6*	*3.4*	*4.3*	*22.0*	*14.7*
Forestry and fisheries	594	*23.7*	*19.8*	*5.2*	*–3.6*	*17.6*	*24.3*
Intermediate consumption (–)	5,237	*25.3*	*18.1*	*4.6*	*4.0*	*19.8*	*13.6*
Contributions to production (+)	642	*–4.9*	*32.4*	*–22.8*	*30.9*	*23.2*	*1.1*
Value added at factor cost	13,698	*15.2*	*17.5*	*–5.4*	..	*21.8*	*17.5*

Source: *Relazione generale sulla situazione economica del paese.*

Only in livestock breeding did all sectors obtain good results, confirming the favourable trend of recent years. Pig-breeding in particular, under the stimulus of consumer demand which then declined later in the year, recorded the largest expansion (11 per cent) but cattle-raising also continued on an upward course (4.3 per cent) since premiums were awarded to increase Italy's stock of breeding animals.

In line with the general slackening of inflationary tension, the average level of agricultural prices, i.e. the implicit price of marketable production, rose less rapidly than in 1976 (17.4 versus 21 per cent), a change that should be viewed in relation to a smaller devaluation of the green lira (6.5 per cent at April 1977 against 11 per cent during 1976) and almost stationary food consumption (0.7 per cent rise). Nevertheless, it proved necessary to devalue again the green lira by 6 per cent in February 1978.

For many years now the inadequacies of Italy's agricultural and food production system have placed a considerable constraint on the expansion of the economy, where the size of the external deficit is the most concise and immediate indicator of its present structural crisis. 1977 saw a further worsening of the negative balance for agriculture and food, considering that the deficit on agricultural produce (food and non-food) reached 3,443 billion compared with 3,154 the previous year and that, if the products of the food industry are included, the total rises to 5,708 billion against 5,176 in 1976.

Industry

After little over a year of rapid growth, production in industry excluding construction began, from the very start of 1977, to decline. This trend continued over the year and brought production levels in the last months of 1977 close to those of early 1976; the year-on-year decrease in the fourth quarter of 1977 was 7.6 per cent. On average, however, production volumes were slightly higher than in 1976, having increased by 1.4 per cent in value added terms at 1970 prices (Table 8) and by 0.9 per cent according to the index of industrial production.

Table 8

VALUE ADDED IN INDUSTRY AT MARKET PRICES

Items	Values at 1970 prices in billions of lire			Percentage break-down	Percentage changes		
	1975	1976	1977	1977	1975/74	1976/75	1977/76
VALUE ADDED:							
including construction .	26,301	28,879	29,187	*100.0*	*−8.8*	*9.8*	*1.1*
excluding construction .	21,702	24,313	24,648	*84.4*	*−9.1*	*12.0*	*1.4*
Products:							
of industrial processing .	17,938	20,167	20,557	*70.4*	*−9.5*	*12.4*	*1.9*
fuels	3,764	4,146	4,091	*14.0*	*−6.8*	*10.1*	*−1.3*
Construction	4,599	4,566	4,539	*15.6*	*−7.4*	*−0.7*	*−0.6*

Source: *Relazione generale sulla situazione economica del paese.*

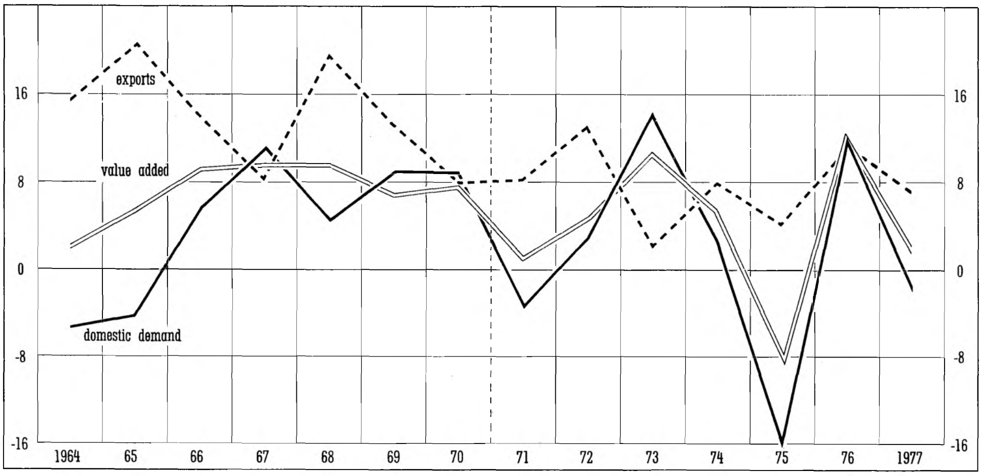
Again on average, value added in the entire industrial sector recorded an even smaller increase (1.1 per cent) owing to a fall in output (0.6 per cent) in the construction industry for the third year running.

Production in industry excluding construction was influenced principally by the trend of domestic demand. The measures relating to taxation and public utility charges introduced in order to improve the external deficit caused a rapid decrease in actual production volumes by reducing demand.

Furthermore, inventory building provided less support to production than in 1976 since enterprises were deterred from increasing stocks by the slowing of both actual and expected inflation rates and by the growing impact of monetary policy on the cost and availability of finance for working capital.

Consequently exports again acted to offset the fall in aggregate domestic demand. Their growth rate, however, was only slightly over half that of the previous year with the result that sales abroad were insufficient to help sustain production levels (Chart 2).

Chart 2



Value added, domestic demand and exports in industry excluding construction
(annual percentage changes at 1963 prices until 1970; at 1970 prices thereafter)

Source: Calculated from Istat data

The increase in production of final capital goods was slightly larger than in 1976 (5.3 against 4.6 per cent), mostly owing to the growth of plant and machinery (up 5.8 per cent in 1977 versus 4.1 the year before). By contrast, levels of activity of firms manufacturing intermediate and final consumer goods were stationary. The reason for this was the fall-off in production of non-durable final goods and the rise in that of durables in response to identical demand trends.

The large rise in prices that accompanied the growth of production in 1976 and the external deficit that grew at a pace with development made it progressively less likely that the upward phase of the cycle could continue for long. It seemed, therefore, that although the growth of production in the fourth quarter of that year was strong it was destined to peter out fairly soon. And in fact it turned out to be concentrated entirely in the last two months of 1976, tailing off in January 1977. By February there was already a sharp fall (down 3.9 per cent from the previous month), the beginning of a continuous downward trend that lasted until June.

Nevertheless, on average for the first quarter of 1977 the general index of industrial production, corrected and seasonally adjusted, was still 1.7 per cent higher than the previous quarter (Table 9)

Table 9

INDEX OF INDUSTRIAL PRODUCTION (1)

(1970=100)

Period	General index: including construction	General index: excluding construction	By sector of destination: Intermediate and producer goods	By sector of destination: Final capital goods including construction	By sector of destination: Final capital goods excluding construction	By sector of destination: Final consumer goods	By branches of activity: Mining and quarrying	By branches of activity: Manufacturing	By branches of activity: Gas and electricity	By branches of activity: Construction
1975 - average	105.5	108.5	107.8	98.5	106.6	110.3	94.7	107.5	126.0	93.7
I qtr.	107.1	109.7	109.4	102.8	113.1	108.6	98.0	108.7	126.8	96.7
II "	105.0	107.6	107.0	98.9	106.4	108.9	93.2	106.6	124.2	94.5
III "	102.4	104.8	103.2	95.8	101.0	108.9	90.1	103.8	121.8	92.7
IV "	107.6	111.8	111.7	96.4	105.8	114.8	97.5	110.7	131.2	90.8
1976 - average	116.2	122.0	122.2	99.8	111.4	126.4	98.9	121.1	140.6	93.0
I qtr.	111.2	116.1	116.7	96.2	103.6	121.0	100.2	114.9	136.5	91.8
II "	116.7	122.3	122.7	99.8	109.0	127.7	102.2	121.4	139.9	94.4
III "	115.6	121.3	122.4	100.5	113.1	123.7	98.3	120.3	142.3	93.0
IV "	121.1	128.2	127.1	102.9	120.1	133.4	94.9	127.8	143.6	92.8
1977 - average	116.9	123.1	122.2	101.7	117.3	127.1	93.9	122.3	143.0	92.5
I qtr.	123.0	130.4	129.0	105.4	125.5	134.5	94.5	130.3	142.8	93.5
II "	116.4	122.3	122.3	102.0	117.2	124.6	90.8	121.5	142.0	93.1
III "	115.3	121.3	118.8	99.7	113.5	128.4	92.4	120.4	141.8	91.6
IV "	113.1	118.5	118.7	99.6	113.1	120.6	98.0	116.9	145.3	91.6
1978 - I qtr. (2)		121.6	122.7		117.9	121.3	98.1	119.8	150.4	

Source: The indices of industrial production excluding construction are calculated from Istat data; in the case of construction, data from the *Relazione generale sulla situazione economica del paese* have been used.

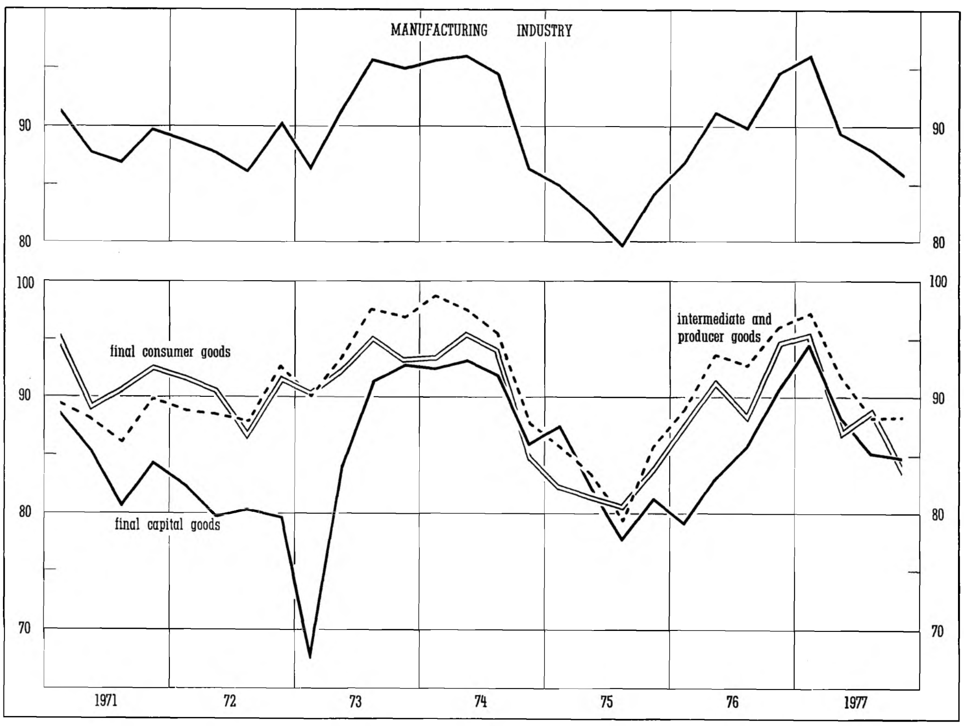
(1) Corrected for months with an equal number of working days and seasonally adjusted. – (2) Sectoral data refer to January-February. The indices for 1978 have been adjusted to take account, in each sector, of the increase in the number of working days compared with 1970.

and 6.9 per cent over the average for 1976. During the same period aggregate demand decreased owing to the drop in exports and consumption: these trends produced a substantial rise in inventory building.

In the second quarter industrial production showed a marked decrease (down 6.2 per cent from the first quarter) which coincided with the recovery of aggregate demand brought about by the upturn in sales abroad and consumption, so that it was possible to reabsorb the rise in inventory levels.

Plant capacity utilization peaked in the first quarter and then began a rapid decline that continued throughout the year (Chart 3).

Chart 3



Capacity utilization in manufacturing industry

In the three months after June, which had seen a further large drop in production, activity levels rose moderately. Nonetheless, on average for the third quarter, the seasonally adjusted index was 0.8 per cent lower than in the previous quarter.

Although the mild recovery of production during the summer did not endure, in the second half-year the amount of goods invoiced and orders received and expected by large firms began to stabilize. However, production continued to decline in October and November and in December again recorded a net decrease (2.8 per cent) which brought down the average for the fourth quarter considerably (down 2.4 per cent from the previous quarter). The December decrease, after five months of relative stability, proved more or less isolated in view of production trends in early 1978: in January the corrected and seasonally adjusted index recorded a 4.7 per cent increase followed by a further, though smaller, rise in February (0.5 per cent).

According to provisional figures, the March index of industrial production has not changed from February, so that on average for the first quarter of 1978 there was a 2.6 per cent increase in production from the previous quarter.

Services

The largest contribution to the formation of gross domestic product in 1977 came from marketable services which increased from the previous year at over twice the rate of the other branches (3.4 per cent; Table 10). As regards the value added of this sector, the

Table 10

VALUE ADDED AT MARKET PRICES OF MARKETABLE SERVICES

(billions of lire)

Branches	1977				Percentage changes			
	Absolute values		Percentage breakdown		Quantity		Prices	
	prices				1976/1975	1977/1976	1976/1975	1977/1976
	current	1970	current	1970				
Commerce and catering	24,643	10,895	*35.5*	*37.3*	*4.1*	*2.5*	*18.4*	*17.2*
Transport and communication	9,733	4,749	*14.0*	*16.3*	*6.2*	*5.3*	*20.1*	*17.4*
Credit and insurance	10,351	3,168	*14.9*	*10.9*	*5.7*	*5.3*	*11.7*	*15.8*
Other services	14,241	5,929	*20.5*	*20.3*	*2.7*	*3.7*	*13.5*	*15.3*
Services, excluding lettings	**58,968**	**24,741**	***84.9***	***84.8***	***4.3***	***3.7***	***16.3***	***16.6***
Lettings	10,481	4,449	*15.1*	*15.2*	*1.8*	*1.8*	*15.0*	*15.2*
TOTAL	**69,449**	**29,190**	***100.0***	***100.0***	***3.9***	***3.4***	***16.1***	***16.3***

Source: *Relazione generale sulla situazione economica del paese.*

cyclical increase was as usual less marked than in industry, while the growth rate was close to that for the previous year, even though the trend of aggregate demand had reversed during the period 1976-1977. One of the reasons why the value added of marketable services has broken away from the trend of aggregate demand is that some important changes have been made in the contents of the various demand items, principally owing to the extremely large increase in tourist activities. It is in fact due to the considerable rise in the number of foreign customers that the change in value added of catering and commerce, though lower than the previous year, was similar to the medium run figure.

The other major branch favourably affected by the expansion of tourism was transport and communications, where value added rose by 5.3 per cent at 1970 prices, after a sizeable increase in 1976.

The energy balance

The poor growth rate recorded on the whole for 1977 did not fail to show up in domestic demand for primary sources of energy which, according to the available estimates, decreased by 1 per cent in volume from the previous year (Table 11). With industry's demand for energy stationary, this decline was due to reduced energy consumption in other sectors, except transport where the increase was caused by the rise, during 1977, in diesel oil for vehicles (16.1 per cent). As regards power for domestic and commercial uses, there was a 10.2 per cent decrease in sales of fuel oil and diesel oil for heating, partly in response to price rises (27 per cent for diesel oil).

On the supply side, since the weather was particularly favourable in 1977 production of hydro-electric power equalled 52.8 billion kWh, or 31.7 per cent of total production.

The joint effect of lower domestic demand for energy and greater production of hydro-electric power made it possible, on the one hand, to cut down on domestic uses of oil by 3.4 million TOE, with a saving of foreign exchange of around 300 billion lire, and on the other to limit domestic production of natural gas.

Current trends seem to point to the beginning of a process of energy saving and substitution among sources set in motion by the rise

Table 11

ENERGY BALANCE

(millions of TOE)

Sources and uses	1976 Solid fuels	1976 Natural gas	1976 Oil	1976 Electric power (1)	1976 Total	1977 Solid fuels	1977 Natural gas	1977 Oil	1977 Electric power (1)	1977 Total
Production	1.1	12.9	1.0	10.4	25.4	0.9	11.3	1.1	12.9	26.2
Imports	9.5	9.8	110.9	0.9	131.1	9.8	10.7	114.0	1.2	135.7
Exports (–)	0.6	–	15.3	0.7	16.6	0.5	–	18.6	0.6	19.7
Changes in inventories (–) (2)	–0.3	0.5	–1.5	–	–1.3	–	0.3	1.8	–	2.1
Domestic uses of primary sources (3)	**10.3**	**22.2**	**98.1**	**10.6**	**141.2**	**10.2**	**21.7**	**94.7**	**13.5**	**140.1**
Percentage breakdown	*7.3*	*15.7*	*69.5*	*7.5*	*100.0*	*7.3*	*15.5*	*67.6*	*9.6*	*100.0*
Tranformation into electric power	–2.1	–3.2	–20.2	25.5	–	–2.2	–2.5	–18.7	23.4	–
Consumption and losses (–)	2.2	0.1	6.8	5.8	14.4	1.5	0.1	7.1	5.3	14.0
Domestic uses of final sources (3)	**6.5**	**18.9**	**71.1**	**30.3**	**126.8**	**6.5**	**19.1**	**68.9**	**31.6**	**126.1**
Percentage breakdown	*5.1*	*14.9*	*56.1*	*23.9*	*100.0*	*5.2*	*15.1*	*54.6*	*25.1*	*100.0*
Industry	*4.7*	*9.6*	*17.3*	*18.6*	*50.2*	*4.8*	*9.7*	*16.7*	*19.0*	*50.2*
Transportation (3)	*0.1*	*0.3*	*25.4*	*0.9*	*26.7*	*0.1*	*0.3*	*25.7*	*1.0*	*27.1*
Other energy uses	*1.4*	*7.1*	*22.1*	*10.8*	*41.4*	*1.3*	*7.4*	*20.3*	*11.6*	*40.6*
Non-energy uses	*0.3*	*1.9*	*6.3*	–	*8.5*	*0.3*	*1.7*	*6.2*	–	*8.2*

Source: For 1976 figures are calculated from Ministry for Industry, Trade and Handicrafts provisional data; for 1977 estimates have been used.

(1) Calculated on the basis of a conventional and constant thermoelectric input of 2,200 Kcal per kWh; the difference between conventional and actual input (2,189 in 1976 and 2,170 in 1977) is offset under "consumption and losses". – (2) Including changes in ENEL's inventories of fuel oil, amounting to –0.7 million TOE in 1976 and 0.9 million TOE in 1977. – (3) Including international maritime bunkers.

in oil prices which, because of its size and suddeness, had originally been almost entirely met with price adjustments in the user sectors.

The recovery of domestic demand for primary sources during the year to levels recorded before the advent of the oil crisis has therefore conformed with the tendency to limit the use of oil. In fact, whereas in 1963-1972 the income elasticity of oil consumption was over 2, in 1973-1977, against an average annual rate of increase of income of 2 per cent, primary uses of oil decreased on average by 2.6 per cent.

However, it seems unlikely that the slowdown in domestic demand for oil will continue in the near future considering the moderate overall growth rate of the last five years and, more importantly, the stagnation or even decrease, albeit reversable, in highly oil-intensive production industries (metalworking, chemicals, building materials).

Employment, wages, prices and the distribution of income

Employment

In 1977 total employment rose by 0.4 per cent (Table 12), so that during the 1975-1977 cycle the increase was 1.1 per cent against 2.5 per cent in the previous one (1972-1974).

During recent years the economic system has had difficulty in keeping the rate of job-creation at a pace with the rise in the supply

Table 12

EMPLOYMENT IN ITALY

(yearly percentage changes)

Sectors and branches of activity	Employed labour force					Employees in employment				
	1973	1974	1975	1976	1977	1973	1974	1975	1976	1977
Agriculture	−3.2	−2.5	−4.7	−0.9	−2.3	−1.2	−1.9	−5.0	1.5	−1.1
Industry	0.5	1.5	−0.3	−0.1	−0.1	0.6	1.7	−0.5	−0.3	−0.2
Energy products	*−0.5*	*3.6*	*4.2*	*2.7*	*−0.2*	*−0.5*	*3.6*	*4.2*	*2.7*	*−0.2*
Product of industrial processing	*1.6*	*2.3*	*−0.2*	*0.3*	*0.1*	*2.2*	*2.5*	*−0.4*	*0.2*	*0.1*
Total industry excluding construction	*1.6*	*2.4*	*0.1*	*0.3*	*0.1*	*2.1*	*2.6*	*−0.2*	*0.3*	*0.1*
Construction	*−2.8*	*−1.1*	*−1.1*	*−1.7*	*−0.8*	*−3.7*	*−1.3*	*−1.5*	*−2.5*	*−1.3*
Marketable services	2.1	3.1	1.8	2.3	2.0	3.5	4.0	2.5	2.6	2.2
Commerce, catering & entertainment	*2.0*	*2.5*	*0.8*	*1.1*	*1.6*	*4.2*	*2.2*	*0.9*	*1.1*	*2.2*
Transport and communication	*1.8*	*2.8*	*1.6*	*2.6*	*1.1*	*2.4*	*4.3*	*1.3*	*2.3*	*0.9*
Credit and insurance	*5.4*	*7.7*	*7.6*	*5.9*	*4.5*	*5.3*	*7.7*	*7.6*	*5.8*	*4.5*
Miscellaneous services	*2.1*	*4.1*	*3.4*	*3.9*	*2.9*	*2.8*	*5.4*	*4.3*	*4.0*	*2.6*
Marketable goods and services	0.3	1.4	−0.3	0.6	0.3	1.3	2.0	–	0.8	0.5
Non-marketable services	3.3	3.1	3.1	1.7	0.7	3.3	3.1	3.1	1.7	0.7
TOTAL	0.7	1.6	0.1	0.8	0.4	1.7	2.2	0.6	1.0	0.5

Source: Istat.

of labour, a situation which shows up even more clearly if one looks at the sectoral development of labour demand. After the brief standstill of 1976, agricultural employment continued to decline at rates close to the long-run trend: total employment decreased by 2.3 per cent, but the fall in the number of workers in employment was smaller (down 1.1 per cent against a 1.5 per cent increase the previous year).

In industry total employment fell slightly (0.1 per cent) owing to the continued decrease in construction (0.8 per cent). Employment in the rest of the sector, however, was more or less stationary (0.1 per cent higher than in 1976), in line with a very small increase in value added (1.4 per cent), after the moderate growth of the two previous years.

The principal features of labour demand during the last cyclical phase thus appear to have been industry's inability to absorb more manpower — between 1974 and 1977 the number of employed persons in fact decreased by 42 thousand — and a marked immunity to albeit massive cyclical fluctuations in output.

Over the last three years the Wage Equalization Fund has played a decisive role in maintaining this stability. It has carried out far more extensive intervention in the seventies than in the second half of the sixties, mostly because cyclical fluctuations in productive activity have been wider, but also because recourse has been of more than a purely short-run nature.

Changes in productivity per man-hour in industry excluding construction followed the variations of production also in 1977. During the recession between the second quarter of 1974 and third quarter of 1975 production decreased by a total of 13.3 per cent and productivity by 8.4 per cent. In the opposite cyclical phase between the end of 1975 and the start of 1977, output and productivity increased respectively by 22.8 and 13.9 per cent.

As a consequence the output elasticity of total hours worked was well below the average for the previous years. This result can only in part be ascribed to the effect of short-term economies of scale, its main cause being the tendency of firms to keep the average level of manpower well above what is strictly required by current levels of production.

Once again employment in large industries (with over 500 employees) recorded the worst performance with a decrease of 1.1 per cent, having continued on the downward trend which began at the end of 1974. The employment policy pursued by these firms during the last cycle was in no way affected by fluctuations in production and the number of employees continued to decline in all branches. The smallest decrease during 1977 occurred in the industries producing capital goods (0.6 per cent) and the largest, as in the past two years, in those manufacturing consumer goods (1.5 per cent).

Employment in the services sector rose less than in previous years (up 1.6 per cent). In marketable services the increase was similar to the previous year (2 per cent) while in non-marketable services at 0.7 per cent it was very much lower than the average for 1970-1976 (3 per cent).

Since January 1977 some alterations have been made in the quarterly surveys on the labour force in order to give fuller information on a wider range of phenomena. It has thus been possible to give a more accurate picture of the true labour market situation in response to the many requests for such data, although some problems of comparability have been created.

By broadening the definition of employed and unemployed persons the size of the labour force has been increased, and thus averaged 21,607,000 for the year. The participation rate (38.9 per cent) was therefore closer to that of the major industrial countries.

The unemployment rate, calculated as the ratio of total unemployed persons (including students, housewives, pensioners etc. looking for work) to the labour force, was 7.2 per cent (12.6 per cent for women), varying widely from one part of the country to another: 5.1 per cent in Northern Italy, 7.6 per cent in Central Italy and 10.1 per cent in the South and Islands.

The number of unemployed (according to the old definition) increased by a record 23.5 per cent, but if the effect of the changes in the sample surveys is excluded, the increase from 1976 drops to around 14.5 per cent. This increase was almost entirely due to the massive rise in the number of people in search of their first job, from 619 thousand in January 1977 to 754 thousand in January this year.

The unemployment rate, calculated on data that can be compared with those used in the old survey, shows an increase from 3.7 per cent in 1976 to 4.2 per cent in 1977, having risen uninterruptedly since the third quarter of 1976.

Wages

One of the main features of trade union activity in 1977 was the drop in the number of labour disputes. Around 75 million hours were lost in disputes over contracts, the lowest figure since 1969, and even if hours lost in conflicts over other issues are included (totalling 35 million, of which 29 in industry) the level remains well below that of recent years. Since the major national contracts had been renewed in 1976, the few disputes which did take place in 1977, though important, only concerned a small number of workers.

The fact that disputes on issues other than labour contracts, though limited, still accounted for almost a third of total hours lost (40 per cent in industry) shows that the conflict between unions and Government on the more important aspects of economic policy continued throughout 1977. Once agreement on the cost of labour had been reached first with the Confindustria (General Confederation of Italian Industry) and then with the Government (as discussed in last year's Report), the unions turned their attention, particularly towards the close of the year and in early 1978, to the problems of safeguarding and increasing employment (especially among the young and in Southern Italy) and changing the structure of labour costs and to the question of labour mobility. Apart from the various statements of principle, some differences of opinion arose between the major unions on the content of the proposed reforms and innovations, as well as on the phases of their implementation.

Some of the changes and innovations proposed during the debate on the structure of labour costs were extremely precise and detailed and all were certainly far-reaching, although their effects at the aggregate and the sectoral and company level have not yet been examined. They will undoubtedly form one of the basic points at issue during the renewal of the major national contracts expiring between the end of this year and mid-1979.

The growth of minimum contractual wages in 1977 was higher than the previous year in all sectors except credit and insurance (Table 13). However, the percentage changes in wages gradually decreased during the year as inflationary pressures let up and produced smaller sliding scale pay rises. In industry and agriculture in particular the December 1976 to December 1977 increase was much lower than

Table 13

GROSS MINIMUM CONTRACTUAL WAGES (1)

(percentage changes)

Sectors	1976 / 1975	1977 / 1976	Dec. '76 / Dec. '75	Dec. '77 / Dec. '76
WAGES				
Agriculture	25.1	31.7	33.6	23.1
Industry	20.4	26.7	28.0	22.8
Mining and quarrying	21.7	27.6	29.5	23.7
Manufacturing	20.9	27.6	28.9	23.3
foodstuffs	*15.2*	*27.3*	*20.6*	*28.4*
textiles	*22.4*	*30.9*	*34.0*	*23.8*
metals and engineering	*22.3*	*25.8*	*30.2*	*21.2*
chemicals	*22.4*	*27.6*	*28.8*	*24.7*
Construction	19.6	24.7	26.1	21.6
Electricity and gas	16.3	23.9	20.8	20.7
Commerce	16.3	32.5	18.8	31.0
Catering and entertainment	23.9	28.2	24.9	27.2
Transport	21.1	26.1	24.4	23.8
Communication	13.6	22.2	16.9	19.7
SALARIES				
Industry	16.8	21.5	21.7	18.9
Commerce	14.4	27.1	16.2	25.9
Catering and entertainment	21.8	26.6	22.7	25.4
Transport	16.6	20.2	17.8	19.4
Communication	13.9	19.4	11.5	21.5
Credit and insurance	16.1	15.0	19.8	10.2

Source: Istat.
(1) Excluding family allowances.

the year-on-year increase. Instead, in the services sector the average increases were moderate but large rises occurred during the year owing to the 1976 contract renewals (which only became effective in 1977) and to wage rises linked to staff reorganization in certain sectors.

Once again the highest increase was recorded in the agricultural sector (31.7 per cent), owing to rises in minimum contractual wages in the second half of 1976 and to relatively larger sliding scale increases because wages in this sector are lower than in others.

The increases in minimum contractual wages in industry (26.7 per cent for blue-collar and 21.5 per cent for white-collar workers) were tied not only to the sliding scale (a total increase of 24 points in 1977 compared with 20 the year before) and to the renewal of most national contracts in 1976, but also to the agreements reached during 1977 in the rubber, plastics and printing industries.

The largest increases in the services sector were recorded in commerce (32.5 per cent for workers and 20.2 per cent for employees) where the agreement reached in 1976 became effective on January 1st 1977. The smallest rise was in credit and insurance where the year-on-year increase in wages was 15 per cent, and that between December 1976 and December 1977 even smaller (10.2 per cent).

Wage differentials narrowed even further in 1977. The unification of the sliding scale systems obtaining in the different sectors and the contract renewals of the last two years — both of which gave equal increases to all employees — did much to iron out wage differences, as one can see from the changes in real earnings. This tendency towards wage equalization has greatly altered the distribution of incomes from employment in recent years and reduced wage differentials between sectors, between branches of production within these sectors, and also between employees in the same branches and firms with different qualifications and professional status.

Actual hourly earnings of employees in industry excluding construction are estimated to have increased, in money terms, by around 25 per cent between 1976 and 1977 (23 per cent between the last quarters of the two years), of which two thirds was due to the sliding scale system. It should also be noted that since the second phase of the programme to unify the value of the sliding scale point began (February 1976), automatic wage increases linked to point increases in the trade union cost-of-living index have begun to prevail over other types of increase, even though 1976 was a year of large contractual rises. This phenomenon was entirely absent in the first half of the seventies, with the sliding scale mechanism providing less and less coverage until it reached a low of around 40 per cent in 1974. The January 1975 agreement between the Confindustria and the unions, which sanctioned the gradual unification of the sliding scale point at the highest level (this programme was completed in February 1977), gave a degree of coverage which in 1977 was almost equivalent to fully indexed wages for employees in industry excluding construction.

In 1977 unit labour costs in the private sector grew at a much faster pace than the previous year (18.9 against 14.9 per cent). The increase in the labour cost per employee (20.7 per cent) was more or less the same as in 1976, whereas the rise in productivity was 4 points lower.

The increase in the cost of labour in fact was less than it should have been because of the measure introduced at the beginning of the year to take up part of the social security contributions of employers in industry excluding construction (later extended to some branches of commerce and catering) and because of the abolition of increases in severance and retirement bonuses linked to the sliding scale. However, it should be recalled that since the latter are accounting entries it is only when the employer-employee relationship ends that the firm's outlays for severance pay decrease.

There was a considerable drop in the growth rate of output per man in industry (from 10 per cent in 1976 to 1.2 per cent in 1977) which was largely due to the moderate trend of production combined with a slight fall in employment. Although the measure to reduce part of the social security contributions paid by industry meant a smaller growth of the labour cost per employee than in the previous year (20 per cent) it did not offset the slowdown in the growth rate of productivity. Unit costs thus grew by 18.6 per cent in 1977 against 12.1 per cent in 1976.

The growth of labour costs was higher in agriculture, where the cost per unit of output increased less than the cost per employee (27.9 and 28.6 per cent respectively). This result was due to a slight increase in productivity which, however, was caused by employment decreasing more than value added (2.3 per cent and 1.7 per cent respectively).

In the services sector instead the 3.6 per cent increase in value added and 1.5 per cent rise in employment were matched by a growth of the labour cost per employee of over 20 per cent and a slightly smaller rise in unit costs (17.9 per cent) than in industry.

Prices

Inflation, which has been under way in Italy since the end of the sixties, continued at high rates during 1977. Upward pressure on prices, however, slackened considerably during the year, even though in all sectors unit labour costs rose more than the previous year. The price trend, therefore, was determined to a large extent by the fall in international prices for raw materials, the stability of the lira exchange rate and the slowdown in the domestic and international cycle, which together dampened the growth of domestic prices.

The general index of wholesale prices grew by 16.6 per cent on average for 1977, but this large increase conceals a marked slackening of inflation from 31.5 per cent at the start of the year to 9.5 per cent in December. The slowdown occurred in two distinct phases which more or less coincided with the two halves of the year. Until May the general index rose at an average monthly rate of 1.1 per cent in response to the sharp rise in prices for industrial raw materials: in fact, despite a more or less stable exchange rate, these prices were affected by the strong performance of quotations on supply markets. From June on, when the first signs of a slowing of productive activity appeared and the fall in prices of raw materials and semi-finished goods on international markets became established, the average monthly growth rates of the general index dropped to half those of the first part of the year.

Data on the first quarter of 1978 confirm this slowdown in the growth of wholesale prices. In March the general index was 7.8 per cent higher than the year before and 2.3 per cent above the value for the end of 1977 (9.2 per cent on a yearly basis; Table 14).

The general index of consumer prices recorded on average for 1977 an increase almost equal to that of the previous year (17 against 16.8 per cent). During the year, however, there was a gradual slowdown from 22 per cent in 1976 to 14.1 per cent in 1977 (Table 15). Nonetheless these results were not enough to prevent Italy from recording the highest rate of inflation of the major industrial countries.

Although monthly increases were larger during the year consumer prices followed much the same pattern as wholesale prices. The two

Table 14

DOMESTIC WHOLESALE PRICES

(percentage changes of indices, 1976=100)

Indices	1976 / 1975	1977 / 1976	Dec. '76 / Dec. '75	Dec. '77 / Dec. '76	June '77 / Dec. '76	Dec. '77 / June '77	Mar. '78 / Dec. '77
					(on a yearly basis)		
ISTAT							
General index	22.9	16.6	31.5	9.5	11.5	7.1	9.3
Classification by origin:							
Agricultural	23.9	17.7	27.8	14.7	13.6	14.8	11.5
Non-agricultural	22.8	16.4	32.1	8.8	11.2	6.0	9.0
Classification by product:							
Foodstuffs	21.2	17.4	27.7	13.1	11.3	14.0	9.4
Vegetable	21.9	19.6	27.9	16.7	20.8	11.4	12.6
Animal	23.3	14.2	20.9	11.2	0.9	21.4	9.2
Food manufactures	19.9	17.2	30.7	11.8	9.6	13.4	7.8
Industrial raw materials and manufactures (1)	23.5	16.3	32.7	8.1	11.4	4.5	9.4
Raw materials	27.8	12.2	41.9	4.3	8.3	0.4	10.2
Manufactures	21.6	18.1	31.5	9.7	12.8	6.3	9.2
Classification by use (2):							
Consumer goods	23.8	19.8	33.4	12.3	13.6	10.2	10.8
Capital goods	19.8	16.3	27.9	12.1	15.6	8.1	8.3
Producer goods	24.7	14.0	30.8	6.7	9.2	4.0	7.9
MILAN CHAMBER OF COMMERCE							
General index	25.0	15.6	34.9	4.9	9.5	0.2	11.6
Foodstuffs	26.6	18.7	31.7	9.6	11.5	7.4	19.7
Industrial raw materials	24.3	14.4	36.2	3.0	8.8	−2.6	8.2

Source: Istat.

(1) With respect to the data used until 1976, from 1977 "industrial raw materials" include "crude oil", "quarry-stones", "sawn wood", "cement and similar"; in turn "industrial manufactures" include "manufactures in cement and similar". — (2) With the introduction of the new Istat classification (1976=100), there have been some changes in the classification by use. More specifically, "capital goods" no longer include "construction materials" (which now come under "producer goods"), "cars", "motor-vehicles" and "bicycles" (now under "consumer goods").

peaks of inflation in the early months of the year and in autumn were matched by a considerable slowdown during the summer. Over the first five months retail prices rose on average by 1.4 per cent (1.1 per cent for wholesale prices) and by 0.9 per cent during the rest of the year (0.5 for wholesale). Two of the reasons for the increases of the first six months were the rise in many public utility charges and the change in some indirect taxation rates decided as part of the economic stabilization programme begun at the end of the previous year.

Table 15

RETAIL PRICES AND COST OF LIVING

(percentage changes of indices, 1976=100)

Indices	1976 / 1975	1977 / 1976	Dec. '76 / Dec. '75	Dec. '77 / Dec. '76	June '77 / Dec. '76	Dec. '77 / June '77	Mar. '78 / Dec. '77
					(on a yearly basis)		
RETAIL PRICES							
General index	16.8	17.0	22.0	14.1	15.7	11.5	12.6
Food products	17.1	16.9	22.5	15.2	16.4	12.9	10.7
bread and cereals	13.5	15.5	16.9	14.7	17.3	11.1	22.7
meat	20.1	12.3	20.9	9.4	7.8	10.6	10.6
sugar	15.8	16.5	19.0	12.9	5.7	19.5	0.3
coffee	40.2	89.8	73.7	49.3	107.9	−6.0	−18.6
Non-food products and services	16.5	17.1	21.5	13.4	15.5	10.4	14.0
clothing and footwear	16.0	22.6	21.8	20.2	19.7	18.9	11.4
hygiene and health	8.8	9.5	10.2	11.0	7.3	14.2	15.9
furniture, furnishings, equipment and services for domestic use	15.0	17.8	21.0	14.7	19.5	9.1	10.7
fuel and electricity	12.8	28.4	31.3	12.7	19.2	5.6	20.8
heating fuel	*21.6*	*34.9*	*40.7*	*115.4*	*23.6*	*6.4*	*28.0*
housing	12.0	6.0	14.2	5.6	4.8	6.1	8.8
transport and communication	26.9	20.4	34.4	10.9	15.2	6.1	13.5
cars	*32.2*	*20.7*	*38.7*	*12.9*	*12.9*	*12.2*	*18.2*
State Railways	*4.8*	*28.9*	*10.3*	*21.5*	*43.0*	–	–
recreation, entertainment, education and cultural services	12.7	14.3	11.9	13.3	17.6	8.3	11.7
Non-food products	17.4	19.6	25.5	13.2	15.7	10.0	12.4
Services	15.3	14.2	16.7	13.4	14.9	11.1	16.0
COST OF LIVING							
General index	16.5	18.1	21.8	14.9	17.5	11.4	12.2
Food	16.6	17.6	21.4	15.4	16.9	12.8	10.6
Clothing	16.3	23.4	22.5	20.6	21.6	17.7	11.4
Electricity and fuel	12.9	29.5	30.9	13.0	20.7	4.9	18.9
Housing	10.4	5.8	12.5	6.4	5.1	7.4	11.0
Miscellaneous expenditure	17.9	18.3	22.8	14.3	18.4	9.4	13.5

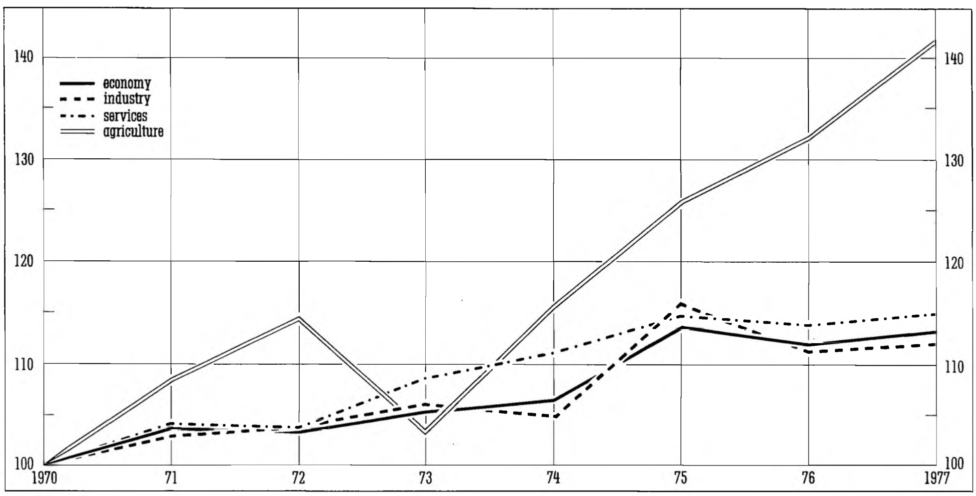
Source: Istat.

Consumer prices continued to slow down in the first quarter of 1978, notwithstanding the 1.3 per cent increase in March from the previous month. The annual rate of change was 12.6 per cent at the end of March, compared with 14.1 per cent at the close of 1977 (Table 15).

The distribution of income

Income from employment (including social security contributions) increased by 22 per cent in 1977 while net national income at factor cost grew by 19.1 per cent. Hence the share of income from employment began to increase once again after the slight decrease of 1976, reaching 71.6 per cent (against 69.9 per cent in the previous year and 64.4 per cent in 1973, the year when inflation began to accelerate in Italy). This increase — which is still observable even if the changes in the breakdown of employment are taken into account (Chart 4) — was

Chart 4



Shares of income from employment in value added corrected for changes in the ratio of employees to total employment

(indices, 1970=100)

Calculated from Istat data

N.B. The services sector includes not only marketable services, net of lettings, but also non-marketable services; in the industrial, services and agricultural sectors imputed bank services are included; in the value added of the economy they are excluded.

limited thanks to the measure for the Government to take up part of employers' social security contributions and to the abolition of sliding scale increases in severance and retirement bonuses mentioned earlier.

The shift in income distribution was particularly marked in agriculture where, alongside a 16.9 per cent increase in value added at market prices, income from employment rose by 27.2 per cent. In industry the improvement in income distribution in favour of capital and entrepreneurial and self-employment incomes which was a major feature of 1976 did not continue into 1977 and the share of these incomes in value added was slightly lower. Income distribution also shifted slightly in favour of employment in the services sector.

THE BALANCE OF PAYMENTS

1977 closed with a balance-of-payments surplus of 2,129 billion lire, which was mainly due to that of 2,014 billion recorded in the current account. The capital account gave rise to a net inflow of 48 billion lire, or 591 billion when 543 billion worth of compensatory loan repayments are excluded. The balancing item, "errors and omissions", amounted to 67 billion lire. The 4,197 billion increase in foreign currency reserves was not only due to the aforementioned balance-of-payments surplus but also to the large inflow of short-term banking funds (3,094 billion; Table 16).

The expansionary stimulus provided by world trade proved to be weaker than had originally been expected as a result of the unsatisfactory course of domestic demand in several major countries. The increase in the volume of exports nonetheless enabled Italy to increase its share of the main markets for its manufactures for the third year running. This result stemmed both from the competitiveness of Italian products, which benefited from exchange rate depreciations, and from the extent to which resources have been transferred from internal to external uses since the oil crisis.

The invisible surplus was substantially larger than in previous years thanks to the exceptional expansion of structurally surplus sectors (tourism, worker earnings and emigrants' remittances).

Table 16

BALANCE OF PAYMENTS ON A TRANSACTIONS BASIS (1)

(billions of lire)

Items	Credit		Debit		Balance	
	1976	1977	1976	1977	1976	1977
CURRENT ACCOUNT	**41,197.5**	**53,017.2**	**43,540.6**	**51,002.8**	**–2,343.1**	**2,014.4**
Goods *(fob)*	30,781.9	39,290.3	34,308.6	39,167.6	–3,526.7	122.7
Oil and oil derivates	*1,684.8*	*2,181.9*	*7,761.9*	*8,771.7*	*–6,077.1*	*–6,589.8*
Services	9,032.3	11,956.9	8,080.0	10,266.6	952.3	1,690.3
Transfer payments	1,383.3	1,770.0	1,152.0	1,568.6	231.3	201.4
CAPITAL MOVEMENTS	**18,023.0**	**21,486.4**	**16,538.9**	**21,438.5**	**1,484.1**	**47.9**
Compensatory loans	–	–	283.0	543.0	–283.0	–543.0
Others	18,023.0	21,486.4	16,255.9	20,895.5	1,767.1	590.9
ERRORS AND OMISSIONS					**–168.8**	**66.7**
TOTAL					**–1,027.8**	**2,129.0**
TOTAL (excluding compensatory loans)					**–744.8**	**2,672.0**
MONETARY MOVEMENTS (2) . .	**11,463.6**	**7,964.8**	**10,435.8**	**10,093.8**	**1,027.8**	**–2,129.0**
Banca d'Italia-UIC	8,330.7	2,238.7	8,525.3	7,300.3	–194.6	–5,061.6
Banks	3,132.9	5,726.1	998.5	2,631.7	2,134.4	3,094.4
Exchange rate adjustments . . .	–	–	912.0	161.8	–912.0	–161.8

(1) For some items the figures in this table, approved by the balance-of-payments Committee, differ from those published in the *Relazione generale sulla situazione economica del paese* since they are based on more recent data and estimates. — (2) Balance with minus sign indicates increase in assets or decrease in liabilities.

Autonomous capital movements together with an inflow of bank funds resulted in a surplus of 3,685 billion lire. If the funds connected with the Fiat-Libya deal are excluded, most of the capital inflow consisted of loans and foreign currency financing in connection with imports and exports. 1977 saw the outflow of capital via the unofficial market dry up almost completely. In fact, since April the so-called parallel rate has been the same as the official rate, testifying to the thinness of this market.

Net euro-currency borrowing during the first half of the year and substantial balance-of-payments surpluses in the second made it possible to increase the foreign currency reserves by nearly 4,200 billion lire, thereby enlarging the scope for more flexible management of the exchange rate.

Goods

One of the main features of the trade balance in 1977 was the fall in the growth rates of both imports and exports — the first from 45.8 per cent in 1976 to 14.2 per cent (on a c.i.f. basis), the second from 36.3 to 27.5 per cent. As a result the trade deficit (2,221 billion lire) was less than half that of 1976. This improvement was mainly due to changes in the volumes of imports and exports — the first contracting by 1.9 per cent with respect to 1976 and the second expanding by 7.0 per cent. As for the terms of trade, they also improved with import unit values rising 16.4 per cent and export unit values 19.1 per cent.

The seasonally adjusted trade balance improved progressively over the year and moved into surplus in the fourth quarter as a result of a better performance of real flows and an improvement in the terms of trade.

For the whole year the link between imports and domestic demand was amplified by the greater recourse made to inventories. The overall effect of price variables on imports was not substantial. The ratio of domestic wholesale prices to import prices did not change markedly during the first three quarters, but at the end of the year the former increased while the latter declined.

Since the volume of Italy's exports expanded by 7 per cent with respect to 1976 while world trade only increased by 4 per cent, Italy's share of the total rose from 6.5 per cent in 1976 to 6.7 per cent.

The improvement in the terms of trade occurred despite the further, albeit small, depreciation of the lira and increases in the dollar prices of raw materials (including oil) which, according to OECD estimates, were close to those of manufactures. The improvement in Italy's terms of trade can, therefore, be attributed to the relatively large rise in the country's export prices which partially offset the increase in competitiveness recorded in 1976.

Services

The 1977 transport deficit of 603 billion lire was virtually unchanged compared with 1976 since the increase in the air transport surplus offset the larger deficits of shipping and overland transport.

In the shipping sector Italy's total expenditure on the transport of imports rose from 2,002 billion lire in 1976 to 2,305 billion. Of this increase 224 billion can be attributed to dry cargo and 79 billion to liquid cargo. Compared with 1976 Italy's expenditure per ton rose for dry cargo and, to a lesser extent, for liquid cargo, with the average cost rising by 15 per cent to 13,000 lire. The earnings of the Italian merchant navy for the transport of exports and third country traffic grew only slowly from 1,072 billion lire in 1976 to 1,200 billion. The overall shipping deficit taking into account passenger earnings and expenditure incurred by fleets abroad, is estimated to have amounted to 615 billion lire in 1977 compared with 528 billion in 1976.

The figures for tourism in the balance of payments on a cash basis were exceptionally good. Earnings at 4,202 billion lire were twice those of 1976, while expenditure at 789 billion only rose 34 per cent. The outcome was that the surplus on tourism increased from 1,512 to 3,414 billion lire.

The increase in earnings can only be accounted for in part by the changes in the normal variables affecting tourism: in fact the number of nights spent by foreign visitors and the cost of tourist services in Italy rose by respectively 8 and 22 per cent. To arrive at a fuller explanation of this development one must examine the intermingling of earnings on tourism and capital movements, a phenomenon which has distorted the figures for tourism on a cash basis since 1970 and which has been amply illustrated in previous Reports.

In 1977 the discount on Italian bank-notes with respect to the official quotation of the lira in Switzerland, a variable with which the distortions of earnings on tourism have been found to be correlated, fell to zero. This was not so much the result of an increase in the demand for bank-notes as of a contraction in their supply.

The shrinking of the market for bank-notes was almost entirely due to two factors: firstly, the improvement in the balance of payments during 1977 which weakened expectations of a further depreciation of the lira and, secondly, the stiffening of the penalties for violation of exchange regulations introduced by Law no. 159 and subsequent amendments. These two factors seem to have substantially reduced the propensity to smuggle capital out of the country, at least through the channels of tourism and emigrants' remittances. As a result it has been possible to enter the tourist earnings on a cash basis into the balance of payments on a transactions basis without making any adjustment.

In the case of Italian tourist expenditure abroad the correction of the data for the share of capital movements they contained was considered to be no longer necessary in 1976. In fact the exchange controls adopted in recent years limiting the sums Italian travellers may spend on trips abroad have proved effective in reducing foreign currency outlays close to the amount necessary to finance Italian tourism abroad.

According to the balance of payments on a cash basis emigrants' remittances increased by nearly 68 per cent with respect to 1976 and totalled 1,246 billion lire.

Capital movements

Capital movements recorded a surplus of 48 billion lire compared with 1,484 billion in 1976. The greater part of the net inflow of foreign capital was accounted for by direct investment which increased from 77 to 1,001 billion, whereas foreign short-term trade credits passed from a net inflow of 3,173 billion to a net outflow of 418 billion. The total net outflow of Italian capital fell from 1,824 to 676 billion. The improvement was mainly the result of a reduction in short-term export credits from 1,983 to 445 billion, and of the apparent disappearance of illegal capital outflows recorded under " other capital " (Table 17).

Table 17

CAPITAL MOVEMENTS

(billions of lire)

Items	Credit		Debit		Balance	
	1976	1977	1976	1977	1976	1977
FOREIGN CAPITAL	**9,462.8**	**10,427.0**	**6,155.0**	**9,703.4**	**3,307.8**	**723.6**
Investment:						
direct	353.7	1,130.7	276.3	129.2	77.4	1,001.5
portfolio	367.1	353.4	471.8	333.9	–104.7	19.5
other	47.8	54.6	36.9	58.6	10.9	–4.0
Loans:						
private	751.2	855.2	797.7	1,132.1	–46.5	–276.9
granted or guaranteed by the Government	290.7	396.6	153.5	166.6	137.2	230.0
Trade credits:						
medium and long-term	365.7	273.2	258.8	246.9	106.9	26.3
short-term	7,117.4	7,087.0	3,944.8	7,504.8	3,172.6	–417.8
Other capital	169.2	276.3	215.2	131.3	–46.0	145.0
ITALIAN CAPITAL	**8,715.8**	**11,172.5**	**10,539.5**	**11,848.2**	**–1,823.7**	**–675.7**
Investment:						
direct	313.8	307.8	446.4	794.1	–132.6	–486.3
portfolio	578.9	729.3	351.6	449.1	227.3	280.2
other	1.5	3.3	1.5	13.7	–	–10.4
sales under Law no. 159	500.4	53.9	–	–	500.4	53.9
Loans:						
private	187.7	234.3	488.5	469.4	–300.8	–235.1
granted or guaranteed by the Government (1)	39.0	37.0	55.4	50.2	–16.4	–13.2
Trade credits:						
medium and long-term	1,766.6	1,995.4	1,278.1	1,767.0	488.5	228.4
short-term	5,327.9	7,811.5	7,311.1	8,256.7	–1,983.2	–445.2
Other capital (2)	–	–	606.9	48.0	–606.9	–48.0
BALANCE	–	–	–	–	**1,484.1**	**47.9**

(1) Including participations in international organizations which amounted to 16.8 billion in 1976. — (2) Consists mainly of the estimates of capital movements "hidden" in service items.

Examination of the credit and debit figures confirms the dominant role which the financing of trade, especially in the form of short-term trade credits, has come to play in capital movements.

Italy's most important medium and long-term assets and liabilities (excluding, therefore, both official reserves and the banks' net foreign liabilities) amounted to respectively 13,347 and 18,163 billion at the end of 1977 (Table 18). If 1978 (during which the monetary authorities must make large loan repayments) is excluded, present commitments will result in an average imbalance between maturing assets and liabilities of 800 billion per year over the period 1979-1981.

Table 18

ITALY'S EXTERNAL FINANCIAL POSITION (1)

(billions of lire)

Items	Position at end-1977	Maturity (2)				
		1978	1979	1980	1981	beyond
Assets	**13,347**	**2,173**	**1,962**	**1,571**	**1,415**	**6,226**
Goods (3) and services (4)	6,634	1,509	1,185	789	590	2,561
Loans (5)	6,713	664	777	782	825	3,665
Liabilities	**18,163**	**4,361**	**2,692**	**2,483**	**2,151**	**6,476**
Goods (3)	358	135	115	58	29	21
Loans (6)	12,273	1,417	1,856	1,928	1,657	5,415
Indebtedness of the official monetary institutions	5,532	2,809	721	497	465	1,040

(1) Exclusively loans and trade credits with a maturity of more than one year. — (2) Foreign currency amounts are calculated at the lira exchange rates ruling at end-1977. — (3) Commitments in connection with supplies already completed or authorized payment of which is deferred for more than one year. — (4) Excluding transactions in connection with the execution of contracts not involving the supply of goods. — (5) Disbursed or to be disbursed, including UIC commitments (partly estimated data). — (6) Including compensatory loans.

Monetary movements

The net foreign position of the Banca d'Italia and the Italian Foreign Exchange Office (UIC) improved by 5,061 billion lire in 1977 (excluding the revaluation of gold holdings) as a result of a substantial external account surplus (2,129 billion) and an inflow of foreign exchange via the banking system (3,094 billion).

Italy's external accounts recorded another surplus in the first quarter of 1978 and this made it possible to repay maturing debts with only limited recourse to reserve assets. In addition to a 502 million dollar reduction in the banking system's net external liabilities, 500 million dollars were repaid to the Bundesbank, 350 million to the EEC and 420 million to the IMF.

Table 19

ITALY'S FOREIGN DEBT AND OFFICIAL RESERVES

(millions of dollars)

Items	1973 Dec.	1974 Dec.	1975 Dec.	1976 Dec.	1977 June	1977 Dec.	1978 March
LIABILITIES							
Monetary institutions	*1,016*	*6,957*	*7,035*	*10,117*	*15,279*	*13,136*	*11,725*
Banca d'Italia-UIC	389	5,638	6,303	7,106	8,056	6,563	5,653
Short-term liabilities	389	70	41	108	177	216	227
Medium and long-term liabilities	–	5,568	6,262	6,998	7,879	6,347	5,426
EEC	–	1,885	1,885	2,409	2,909	2,930	2,588
IMF: stand-by	–	857	1,171	1,162	1,271	170	111
oil facility	–	826	1,706	1,691	1,699	1,747	1,727
Bundesbank	–	2,000	1,500	1,736	2,000	1,500	1,000
Banks (net foreign liabilities)	627	1,319	732	3,011	7,223	6,573	6,072
Non-monetary institutions							
Medium-term liabilities (compensatory loans)	6,063	8,120	7,146	6,811	6,567	6,171	6,107
TOTAL LIABILITIES	**7,079**	**15,077**	**14,181**	**16,928**	**21,846**	**19,307**	**17,832**
OFFICIAL RESERVES							
Gold (1)	7,869	13,073	9,832	9,320	10,035	11,260	12,868
Special drawing rights	414	221	97	91	132	144	260
IMF reserve position	359	–	–	–	–	–	198
Foreign currency	2,181	3,187	1,209	3,132	6,134	7,960	6,741
TOTAL RESERVES	**10,823**	**16,481**	**11,138**	**12,543**	**16,301**	**19,364**	**20,067**

(1) The price used for the valuation of gold is the quotation on the London market at the end of the month indicated, less a 15% safety margin. Since December 1976 a price based on London market quotations has been used for the official valuation of Italy's gold reserves.

The strengthening of the country's external position in 1977 was reflected in an increase in official reserves (6.8 billion dollars) which was considerably more than the rise in foreign debt (2.4 billion). This last increased to 19.3 billion dollars at the end of the year entirely as a result of the growth in the external liabilities of the banking system (Table 19). In fact, liabilities vis-à-vis international institutions and central banks together with compensatory loans contracted in private international markets fell by 1.2 billion dollars over the year.

The year-on-year depreciation of the lira on a trade-weighted basis amounted to 6.9 per cent in 1977, while between December 1976 and December 1977 the lira fell by 4.6 per cent (Table 20).

Table 20

TRADE-WEIGHTED LIRA DEPRECIATION RATE (1)
VIS-A-VIS QUOTATIONS ON 9th FEBRUARY 1973

(monthly averages of the daily rate)

Months	Weighting: geographical distribution of Italy's foreign trade						
	in 1972			in 1974			
	1973	1974	1975	1975	1976	1977	1978
January	–	–12.9	–21.8	–20.4	–22.7	–37.1	–39.9
February	–1.9	–15.8	–21.9	–20.4	–29.4	–37.1	–39.2
March	–5.6	–15.4	–21.6	–20.1	–33.5	–37.4	–39.4
April	–7.7	–16.4	–21.0	–19.6	–37.3	–37.7	
May	–8.7	–17.0	–20.8	–19.2	–35.2	–37.7	
June	–13.4	–18.3	–20.7	–19.1	–34.2	–37.7	
July	–14.7	–17.9	–20.8	–19.4	–33.1	–38.0	
August	–11.4	–18.3	–21.0	–19.8	–33.3	–37.7	
September . . .	–9.8	–18.5	–21.2	–20.0	–34.0	–37.5	
October	–10.5	–20.2	–21.7	–20.5	–34.6	–38.0	
November	–11.2	–21.3	–21.7	–20.5	–35.5	–38.3	
December	–11.5	–21.7	–21.5	–20.4	–36.1	–39.3	
YEAR . . .	**–8.9**	**–17.8**	**–21.3**	**–20.0**	**–33.2**	**–37.8**	

(1) Arithmetic mean of the lira depreciation rates vis-à-vis the 15 main commercial currencies weighted on the basis of i) import shares and ii) export shares.

During the year the management of the exchange rate had to reconcile two objectives: that the cost of imports should be held down, thereby reducing the rate of inflation, and that the competitiveness of exporting sectors should be preserved. Priority was given to maintaining the lira-dollar rate stable which implied accepting a gradual depreciation of the lira with respect to the currencies that rose most against the dollar (the Swiss franc, the deutschemark, the pound sterling and the yen). Stability of the lira with respect to the dollar appeared desirable both because of the large volume of goods invoiced in dollars and so as to avoid large fluctuations of the lira-dollar exchange rate from having destabilizing effects on the foreign currency financing of Italian importers and exporters.

PUBLIC FINANCE

The net indebtedness of the public sector (General Government and autonomous government agencies) increased from 14,870 billion lire in 1976 to 17,290 in 1977 even though receipts grew at a faster rate than expenditure, but remained almost stationary as a ratio of GDP (around 10 per cent; Table 21).

The increase in receipts, from 53,830 to 67,100 billion or almost 25 per cent, was in part due to the stabilization programme implemented at the end of 1976, which is estimated to have provided over 4,000 billion worth of extra yields. Once these additional receipts are excluded the growth rate of fiscal revenues appears rather low, this being due to the fall-off in productive activity, the introduction of a system of separate taxation for family incomes, the decreasing yields from some taxes abolished during the 1974 fiscal reform and, finally, to the changes introduced in 1976 in collection schedules for the tax on interest.

The fiscal burden (measured as the ratio of taxes and social security contributions to GDP) continued to increase, rising from 32.5 to 33.8 per cent. Direct taxation increased by 32.7 per cent, with a considerably heavier burden for households (up 41 per cent) owing to the fiscal drag of personal income tax, the prepayment of part of this tax, and the collection of income taxes for previous years. Owing to increases in rates, the growth of indirect taxation (29.5 per cent) was much higher than that of the tax base. By contrast, social security contributions grew at a slower pace (16.8 per cent) because of the reduction of health insurance contributions paid by companies.

The sector's total expenditure rose from 68,700 to 84,390 billion, at a rate of 23 per cent which is in line with that recorded over the previous two years: as a result its share of GDP went up from 48 to 49 per cent. The largest increase occurred in current spending, especially for interest payments and wages. Instead, social expenditure which is the biggest item and also, over the last decade, the fastest growing, decreased very slightly as a share of national income and still stands at around 20 per cent. In fact, the adjustment of INPS (National Social Security Institute) pensions to rises in the cost-of-living and to wage trends, granted on lst January 1977, was referred to the period

Table 21

PUBLIC SECTOR: CASH OPERATIONS (1)

(General Government and autonomous government agencies - calendar years; billions of lire)

Items	1976	1977	% of GDP 1976	% of GDP 1977
Revenues				
Fiscal revenues	46,779	58,441	32.5	33.8
direct taxation	*12,099*	*16,053*	*8.4*	*9.3*
indirect taxation	*14,850*	*19,227*	*10.3*	*11.1*
social security contributions (2)	*19,830*	*23,161*	*13.8*	*13.4*
Sales of goods and services	3,558	4,251	2.5	2.5
Transfers	1,377	1,464	1.0	0.8
Capital income	1,816	2,339	1.3	1.4
Total, current account	53,530	66,495	37.2	38.4
Capital account revenues	298	606	0.2	0.3
Total	53,828	67.101	37.4	38.8
Disbursements				
Staff wages and pensions	17,062	21,283	11.9	12.3
Purchases of goods and services	6,117	7,651	4.3	4.4
Interest payments	7,915	10,887	5.5	6.3
Transfers (2)	29,856	35,231	20.8	20.4
Total, current account	60,950	75,052	42.4	43.4
Capital account expenditure	8,147	10,655	5.7	6.2
direct investment	*6,216*	*7,489*	*4.3*	*4.3*
transfers (3)	*1,931*	*3,166*	*1.3*	*1.8*
Total	69,097	85,707	48.0	49.5
Deficit:				
on current account	*7,420*	*8,557*	*5.2*	*4.9*
on capital account	*7,849*	*10,049*	*5.5*	*5.8*
Net indebtedness (4)	*15,269*	*18,606*	*10.6*	*10.8*
Net indebtedness, excluding repayment of debts (5)	*14,867*	*17,287*	*10.3*	*10.0*

(1) Taken from the *Relazione generale sulla situazione economica del paese.* — (2) Respectively net of fictitious social security contributions and of State pensions to civil servants and outlays by other public bodies to integrate the pensions of their staff. — (3) Including repayment of public health insurace institutions' debts to hospitals and clinics amounting to 402 billion in 1976 and 1,319 billion in 1977. — (4) Changes in the financial situation, i.e. borrowings less lendings. — (5) Operations specified in footnote (3).

1st August 1975 - 31st July 1976, when the rise in prices and wages was much lower than in 1977.

The effect of budget operations was to redistribute resources away from households and towards firms. The company sector, in fact, received considerable support not only from the shift in fiscal burden mentioned earlier, but also on the side of expenditure since production and investment subsidies rose at a much faster pace than national income.

Owing to the performance of receipts described above and to the failure to reduce expenditure, the overall deficit of the enlarged public sector, as defined in the Letter of Intent to the IMF (to include not only public sector operations but also those of ENEL, purchases of goods and services financed with commercial credit and, finally, loans granted to public enterprises not belonging in the sector) widely overshot the agreed ceiling of 16,450 billion and totalled 21,000 billion (net of bank deposits). However, it should be remembered that the economic situation during the year proved very different from expectations.

The cash requirement of the State sector (Treasury, Central Post Office Savings Fund and autonomous government agencies) amounted to 17,080 billion in 1977, against 14,330 in 1976, while according to the definition agreed with the IMF and EEC they amounted to 16,100 billion, that is 3,000 billion over the 13,100 billion ceiling; this overshooting, however, appeared almost entirely in the fourth quarter of the year. By contrast, budget disbursements were well within the limit set, as were net outlays for extra-budgetary operations if certain special transactions are taken into account. Including in the sector's cash requirement the payment by Central Government of debts previously contracted by public bodies, the figures for 1976 and 1977 rise to 22,460 and 14,740 billion respectively (Table 22).

Over recent years, and more especially in 1977, steps have been taken to charge gradually to Central Government the debts of local authorities, public health institutions and hospitals; in 1977 the debts of provincial and municipal authorities were funded to the tune of 4,320 billion and 1,060 billion worth of the debts of health insurance institutions and hospitals were repaid. Although this programme is helping to restore these bodies to a healthy financial situation, which is necessary before any reforms can be undertaken, it has also made it more difficult to control the economic system's liquidity because of the need to increase issues of Treasury bills and the conversion of frozen credits by banks and suppliers to public bodies into securities. However, it was also accompanied by intervention to increase control over the development of expenditure: in addition to the financing of local authorities' debts being charged to the budget, ceilings were placed on the expansion of some of their current expenditure and on staff recruitment.

Most of the increase in the public debt in 1977 can be ascribed to Treasury bills, which were taken up by banks fairly promptly owing to the

Table 22

STATE SECTOR CASH REQUIREMENTS AND THEIR COVERAGE (1)

(calendar years; on a cash basis; billions of lire)

Items	1975	1976	1977 1st qtr.	1977 Year	1978 1st qtr.
OVERALL CASH REQUIREMENTS (— equals net disbursements)					
Budget deficit	−10,282	−10,406	−2,698	−12,443	−9,219
Minor Treasury operations	−4,103	−1,721	632	−422	319
Extra-budgetary operations	−2,135	−2,610	−1,253	−9,596	−1,695
Total	**−16,520**	**−14,737**	**−3,319**	**−22,461**	**−10,595**
Settlement of debts of provincial and municipal authorities and public health insurance institutions	*−2,393*	*−407*	*−278*	*−5,379*	*−2,491*
Total, net of settlement of debts	**−14,127**	**−14,330**	**−3,041**	**−17,082**	**−8,104**
COVERAGE OF OVERALL CASH REQUIREMENTS					
Medium and long-term bonds excluding Banca d'Italia	3,609	779	416	8,031	3,744
Treasury bills, excluding Banca d'Italia	1,627	1,531	2,717	15,235	1,978
Post Office savings	2,309	2,633	671	3,198	(3)1,895
Borrowing from BI-UIC	8,823	9,936	−515	−4,043	3,092
current account	*560*	*1,694*	*693*	*−420*	*2,696*
Foreign indebtedness	8	2	13	27	16
Other indebtedness	144	−144	17	13	−130
Total	**16,520**	**14,737**	**3,319**	**22,461**	**10,595**
domestic financing:					
short-term	*12,960*	*13,591*	*2,860*	*14,362*	*6,837*
(monetary base creation, through "Treasury")	*7,779*	*11,743*	*213*	*−840*	*4,925*
medium and long-term	*3,552*	*784*	*446*	*8,072*	*3,742*
Net indebtedness (2)	**13,689**	**10,514**	**1,500**	**11,808**	**7,846**

(1) For the 1st quarter of 1978 some figures are estimated. — (2) Changes in the financial situation, i.e. borrowings less lendings. — (3) Of which 1,230 billion lire of Post Office current accounts.

ceiling on bank loans and the large inflow of funds from abroad. Their purchases of Treasury bills for free investment totalled 10,690 billion, against 160 billion worth of reimbursements the previous year. Though much lower than market placements of Treasury bills, those of medium and long-term securities were considerably higher than the previous year (3,300 against 600 billion, net of securities to fund debts) thanks to large issues of two-year Treasury credit certificates. These were well accepted by the market because of their maturity and yield and at 31st December only 1,910 billion worth of the total issue (5,500 billion) were held by the Banca d'Italia. As a result the Treasury's indebtedness with the central bank decreased by 4,040 billion (4,700 billion net of finance to repay debts of public bodies, compared with the 4,000 billion increase agreed with the EEC) and its share in total public debt therefore dropped from 48 per cent in 1976 to 34 per cent in 1977.

Funds raised from Post Office savings accounts decreased from 1,530 to 1,190 billion (excluding the capitalization of interest which amounted to 710 and 1,250 billion respectively in 1976 and 1977, and Post Office current accounts). This result was due to the performance of the differential between interest rates on bank deposits and those on Post Office savings, as well as to the lower growth rate of income.

MONEY AND FINANCIAL MARKETS

As part of the economic policy embarked upon at the end of 1976 with the aim of improving the country's external position and slowing down inflation monetary measures brought about a considerable reduction in the rate of total domestic credit expansion through the combined effect of the security investment requirement and the ceiling on bank lending, both of which were maintained for the whole of 1977. However, since April, when the balance of payments moved back into equilibrium and the rate of inflation moderated, interest rates have been lowered.

The monetary authorities, though well aware of the harmful effects of limiting the banking system's freedom of action for a prolonged period, acted as they did because of the need to guarantee an orderly adjustment of the country's external accounts, especially in view of the commitment with international organizations to remove both the special tax and the deposit on purchases of foreign currency at the beginning of the year. The elimination of the deposit resulted in a large flow of monetary base into the economy, and if this had been absorbed with the normal instruments of intervention there would inevitably have been exceptional increases in interest rates. Direct control of bank lending through the imposition of a ceiling made it possible to limit the effect on interest rates of the measures to regulate the liquidity of the economy.

Total domestic credit expansion, after slowing down in the fourth quarter of 1976 with the reintroduction of ceilings on bank lending, accelerated in the early months of 1977 in the presence of sustained levels of production and investment, and then progressively declined after April. The annual rate of expansion, which had been 23.9 and 16.5 per cent in the first two quarters of 1976, was equal to respectively 19.7, 19.2 and 13.4 per cent in the first three quarters of 1977. Total domestic credit expansion in the twelve months to September 1977 thus amounted to 33,000 billion lire. The ceilings on bank lending contributed to the running down of inventories in the second quarter and, together with the large differentials between domestic and foreign interest rates, caused a further sharp rise in foreign currency lending which rapidly replenished the country's foreign currency reserves. The intermediate targets agreed with international organizations in April were largely respected in the second and third quarters: domestic credit expansion amounted, in fact, to respectively 8,210 and 6,520 billion lire compared with targets of 8,200 and 6,300 billion.

The last quarter saw a substantial increase in the rate of domestic credit expansion which exceeded the target of 10,000 billion by 3,660 billion, mainly as a result of the unpredicted increase in the State sector borrowing requirement.

For the whole of 1977 total domestic credit expansion amounted to 35,850 billion or 17.8 per cent (compared with 33,280 billion or 19.8 per cent in 1976). The limit agreed with the EEC was thus exceeded by 5,250 billion. The funds flowing to the private sector, including the repayment of the deposit on purchases of foreign currency, amounted to 18,700 billion (compared with 14,400 in 1976). The figure for 1977 also reflects the considerable increase in the commercial credits suppliers extended to hospitals.

The balance of payments improved much faster and much more than had been expected so that the financing supplied permitted a sizeable increase in the liquidity of the private sector as can be seen from the course of the ratio of financial assets to gross domestic product. This ratio, after declining to the lowest value recorded in the last ten years in the first quarter, progressively rose, most notably towards the end of the year. On the other hand the funds provided to the company sector increased less and more slowly.

The curbing of credit expansion during the year did not lead to rationing of medium and long-term credit. The special credit institutions, in part as a result of the security investment requirement, were able to satisfy demand which, in any case, remained at the rather low level to which it had already sunk in 1976. The subsidized credit sector suffered somewhat from the delay with which the new laws providing incentives for industry came into effect.

There was a very large fall in Treasury bill interest rates over the year, partly as a result of the ceilings placed on bank lending. Equivalent annual rates for three-month bills fell from 18.23 to 11.80 per cent between March and November. Despite the reductions made in the official discount rate, the fall in interest rates was transmitted to the banking sector only partially and with a certain delay.

The decrease in medium and long-term rates was very small, but these had risen relatively less during the upward phase as a result of the support provided by the security investment requirement and intervention by the Banca d'Italia, and because there were no large offers of securities to the public.

At the same time as interest rates fell large quantities of State securities, and especially short-term ones, were placed, with the public making substantial purchases of Treasury bills. This made it possible to offset the large amount of monetary base created by the State sector borrowing requirement, the refunding of the deposit on purchases of foreign currency, the increase in the banks' external indebtedness, and the balance-of-payments surplus.

The changes made to the term structure of interest rates and the slowing down of inflation made it possible to start a gradual funding of the security portfolios of the banks and, especially in the second half of the year, of those of the public. The average residual life of the

Treasury bonds in circulation increased and, with the yield curve sloping upwards once more, spontaneous demand for medium-term securities became regular again, especially after the offer of variable coupon securities by the Treasury (two-year Treasury credit certificates) and ENEL. In September the Banca d'Italia switched from buying to selling medium and long-term securities in the secondary market, and has continued to sell since then so as to slow down the fall in interest rates in this sector which is still dominated by the security investment requirement and the rationing of issues.

The fall in six and twelve-month Treasury bill rates slowed down at the end of the year and came to a complete stop for three-month Treasury bills. During October and November an unexpectedly large Treasury cash requirement, together with a growing inflow of foreign currency from the balance-of-payments surplus, caused a certain amount of concern with respect to the control of liquidity. As a result of the fall in production, the ceilings previously set on bank lending were no longer as effective in controlling the level of liquid assets so that an even more careful and continuous control of the monetary base in the hands of the banks became necessary.

Prospects for 1978

During the first quarter of 1978 total domestic credit expansion speeded up even further as a result of the expansion of the public sector borrowing requirement. Over the year to March 1978 total domestic credit expansion amounted to 39,200 billion lire or 18.8 per cent, so that the target agreed with the IMF was exceeded by 9,200 billion.

The renewal of the ceiling on bank lending at the end of March is intended to keep liquid assets at a level which will make it possible to prevent an excessive build-up of inventories of imported goods and foreign financial assets in the presence of both a recovery of production and a substantial increase in the liquidity of the economy at the end of 1977 and the beginning of 1978. The ceiling has been renewed for four months, i.e. until July, while waiting for a clearer picture to emerge regarding the effects of the planned measures to reduce the enlarged public sector's expenditure and increase its receipts as well as of any other economic policy measures which may be taken.

At present it is estimated that the enlarged public sector's borrowing requirement, taking into account both the renewal of the fiscalization of employers' social security contributions and the partial repayment of public bodies' previously contracted debts, will amount to 35,000 billion lire in the absence of corrective measures.

A borrowing requirement of this order of magnitude would inevitably lead to domestic credit expansion rising well above the 40,000 billion indicated in the Government programme and thus incur the risk of compromising the results achieved with respect to the balance of payments and the internal and external purchasing power of the lira. In fact, even if a large and increasing proportion of the cash requirement stems from the repayment of previously contracted loans, transfer payments, and the direct financing of enterprises, it cannot be assumed that these disbursements will result in an equally large reduction in the private sector's total demand for credit. Furthermore, these funds are not uniformly distributed over the entire productive system but concentrated in a number of large firms and particular branches of production.

It will only be possible to prepare new guidelines for monetary and financial aggregates compatible with economic policy objectives after the definition of the announced measures to reduce the public sector deficit and control other important economic variables.

The central bank's operations and the regulation of the monetary base

During 1977 control of the monetary base was managed by means of a series of interventions in the monetary and credit fields that differed in several respects from those undertaken in the previous year. On the one hand, the administrative measures affecting the monetary base were lifted, as were the special compulsory reserve requirements and the deposits on purchases of foreign exchange, while on the other direct controls on bank credit, such as the ceiling on bank loans and the security investment requirement, were renewed. The last two measures helped to keep the expansion of the monetary base within limits that were consistent with the intermediate targets of credit policy and with the final goals of restoring external accounts to a balanced position and slowing the pace of inflation. Intervention affecting total bank reserves was used to regulate the overall volume of bank intermediation, and more especially the amount of Treasury bills purchased by banks and interest rates on the money market.

Total monetary base net of Post Office deposits increased by 6,413 billion or 18.9 per cent (4,773 billion and 16.4 per cent in 1976). For the second year running the percentage growth of this aggregate was lower than that of GDP, causing a further drop in the monetary base/GDP ratio. Although the control of total bank reserves produced a stronger impact during certain quarters, over the year as a whole it did not add anything to the already restrictive effects of the other instruments of credit policy, and especially of the ceiling on the expansion of bank loans. Hence the stable conditions attained on the foreign exchange and credit markets at the end of the previous year were in part consolidated and short-term interest rates were reduced at a pace with inflation, i.e. so as not to jeopardize the laborious process of rebuilding currency reserves and the return to a balanced time structure of yields. The aim was also to attract the public back to the securities market and to lengthen the average maturity of the public debt.

After the succession of restrictive measures adopted in 1976 at the start of the year it appeared that the most difficult period for monetary base control was over. Money market rates had begun to fall slightly, with the average weighted yield on Treasury bills placed at auction down from 18.1 in October 1976 to 17.2 in January 1977 and the interbank rate down from 17.3 to 15.7.

At the beginning of 1977 the control of total bank reserves was facilitated by the still moderate expansion of the autonomous components of monetary base creation. In the first quarter, with the Treasury's net cash requirement amounting to no more than 2,500 billion lire, there was a slight destruction of liquidity by the foreign sector, owing to the fact that the almost 1,500 billion autonomous balance-of-payments deficit was partly offset by a 1,181 billion increase in banks' net foreign indebtedness. Moreover, the monthly refunds of the deposit on purchases of foreign exchange had not yet reached their highest levels.

Table 23

MONETARY BASE

(changes in billions of lire)

Items	1975	1976	1977 Year	1977 Quarters I	II	III	IV
			SOURCES				
Foreign sector	**–1,700.3**	**1,092.7**	**5,209.0**	**–318.2**	**2,351.2**	**1,859.7**	**1,316.3**
balance of payments (1)	–732.2	–744.8	2,672.0	–1,498.7	–36.2	2,637.8	1,569.1
interventions	–968.1	1,837.5	2,537.0	1,180.5	2,387.4	–778.1	–252.8
Treasury	**7,779.6**	**11,743.4**	**–840.4**	**213.0**	**–3,647.6**	**202.1**	**2,392.1**
Treasury excluding Post Office deposits	5,470.8	9,137.9	–3,976.9	–454.6	–3,595.4	–288.2	361.3
overall cash requirements	16,519.8	14,737.1	22,460.9	3,319.2	5,772.2	3,910.2	9,459.3
non–monetary financing (2)	–8,740.2	–2,993.7	–23,301.3	–3,106.2	–9,419.8	–3,708.1	–7,067.2
Banks	**–389.0**	**–1,477.0**	**–209.4**	**469.9**	**–266.0**	**–279.5**	**285.0**
Other sectors	**1,191.8**	**–3,981,1**	**4,971.5**	**1,322.7**	**2,303.9**	**286.6**	**1,058.3**
deposits: on imports and purchases of foreign exchange	1,237.3	–3,544.6	3,544.6	1,347.3	2,052.3	144.9	0.1
in foreign exchange	599.9	–650.0	639.4	60.2	175.0	121.8	282.4
TOTAL	**6,882.1**	**7,378.0**	**9,549.5**	**1,687.4**	**741.5**	**2,068.9**	**5,051.7**
TOTAL excluding Post Office deposits	4,573.3	4,772.5	6,413.0	1,019.8	793.7	1,578.6	3,020.9
			USES				
Public sector	**4,123.5**	**4,079.6**	**4,921.7**	**–156.4**	**743.9**	**899.6**	**3,434.6**
Public sector excluding Post Office deposits	1,814.7	1,474.1	1,785.2	–824.0	796.1	409.3	1,403.8
Banks	**2,758.6**	**3,298.4**	**4,627.8**	**1,843.8**	**–2.4**	**1,169.3**	**1,617.1**
compulsory reserves (3)	1,633.7	4,414.8	3,663.8	1,781.8	691.0	508.1	682.9
excess reserves	1,124.9	–1,116.4	964.0	62.0	–693.4	661.2	934.2
			COMPONENTS OF TOTAL MONETARY BASE (4)				
Domestic component (4)	*5,673.7*	*4,329.8*	*564.6*	*1,277.8*	*–1,732.5*	*–402.9*	*1,422.2*
Foreign component (5)	*–1,100.4*	*442.7*	*5,848.4*	*–258.0*	*2,526.2*	*1,981.5*	*1,598.7*
			FACTORS OF CHANGE IN BANKS' MONETARY BASE				
Autonomous (7)	*13,367.1*	*12,557.9*	*23,387.8*	*3,145.0*	*4,305.9*	*7,160.4*	*8,776.5*
Intervention (8)	*–10,608.5*	*–9,259.5*	*–18,760.0*	*–1,301.2*	*–4,308.3*	*–5,991.1*	*–7,159.4*
TOTAL BANK RESERVES	*2,758.6*	*3,298.4*	*4,627.8*	*1,843.8*	*–2.4*	*1,169.3*	*1,617.1*
of which extraordinary deposits	–	*1,343.0*	–	–	–	–	–

(1) Autonomous balance. – (2) Public and bank purchases of Treasury bills at issue and/or on the open market. – (3) Includes cash, Treasury bills and long–term securities deposited against the release of cash. – (4) Excluding Post Office deposits. – (5) Treasury, Banks and Other Sectors (net of compensatory loans). – (7) Foreign sector net of compensatory loans. – (7) Autonomous balance of payments, Treasury cash requirements, *less* notes and coin held by the public and special credit institutions' deposits. – (8) Foreign interventions, non–monetary Treasury financing, financing to the banks, other sectors net of special credit institutions' deposits, *less* public deposits with the Treasury and BI–UIC and Post Office deposits.

To compensate the effect of these factors the central bank placed around 2,300 billion worth of Treasury bills on the open market thus absorbing the excess liquidity; it was assisted in this operation by the existence of the ceiling on bank loans and by a highly cautious interest rate policy, as well as by the new criteria adopted for open market operations which are discussed in the Report for 1976.

The increase in banks' liquid assets brought about a reduction in money market rates: the yield on Treasury bills dropped from 17.9 in March to 15.5 in June and the interbank rate from 16.5 to 14.3. The two-point reduction in the discount rate decided on 11th June underlined the central bank's willingness to accomodate this tendency and help it spread to bank lending and deposit rates. The decline of short-term yields had, in fact, not yet been matched by a reduction in the prime rate, which was falling more slowly as a result of the usual frictional delays and the ceiling on bank credit.

The massive amount of Treasury bills that were placed during the year, the shortness of their average life — in the early months of the year 95 per cent of intervention in securities concerned Treasury bills — and the fact that an extremely large share was taken up by the banks as final holders, encouraged two tendencies that the banking system had displayed for some while: to increase the average liquidity of its assets and to expand the share of credit to the Treasury over total intermediation. The primary objective of the monetary authorities became to change, at least to some degree, this situation by lengthening the average life of the public debt as far as possible and by placing more Treasury stocks with the public. The method principally used was to offer longer term Treasury bills both at issue and on the open market, intervening simultaneously on the volume available at auction and on the prices asked on the secondary market. As a result the average maturity of the bills sold from the central bank's portfolio rose from 3.7 months in the first quarter to 4.5 in the second and 9.7 in the third, only to decline again slightly (to 7.3 months) in the last three months of the year when the banks were less willing to forego their liquidity, partly for reasons of a seasonal nature. The second solution was to offer to the banks and public 1,000 billion worth of two-year Treasury credit certificates, newly created securities with a maturity falling somewhere between that of Treasury bills and four-year Treasury bonds — the medium-term security most frequently issued by the Treasury — and a yield that was highly competitive with that of other securities. Since they carry a minimum coupon rate and are indexed to the interest rates on Treasury bills, these two-year certificates were suitable as a replacement and accompaniment for Treasury bills, so that the banks were able to restore a balanced maturity structure to their portfolios without having to take the excessive risks that expectations of continuing high rates of inflation made inadvisable.

In the second half of the year the growth rate of total monetary base and total bank reserves settled at 17.6 and 22.4 per cent respectively. Although the money and foreign exchange markets continued to display the same tendencies that were present until June, specifically a strong growth of the autonomous components, monetary base control did not present any particular difficulty.

The central bank's assets and the creation of monetary base

During 1977 monetary base creation by the foreign sector was extremely high (5,209 billion). Unlike the previous year it was the outcome of an autonomous balance of payments in surplus for the first time since 1971 (around 2,700 billion) and a 3,094 billion increase in the banks' net foreign debtor position (Table 24).

Table 24

MONETARY BASE: FOREIGN SECTOR

(changes in billions of lire)

Items	1975	1976	1977				
			Year	Quarters			
				I	II	III	IV
Balance of payments (1) . .	-732.2	-744.8	2,672.0	-1,498.7	-36.2	2,637.8	1,569.1
Net foreign position of banks	-356.3	2,134.4	3,094.3	1,232.9	2,522.8	-650.1	-11.3
Compensatory loans	-609.5	-283.0	-543.0	-44.0	-147.0	-127.0	-225.0
TOTAL (2) . . .	**-1,700.3**	**1,092.7**	**5,209.0**	**-318.2**	**2,351.2**	**1,859.7**	**1,316.3**

(1) Autonomous balance. – (2) Including accounting discrepancies between BI-UIC balance-sheet items and the balance of payments.

For the first time over the last ten years, total Banca d'Italia credit to the Treasury decreased (— 4,043 billion). Since direct creation of liquidity by this channel (Post Office savings, Treasury notes and coin and other minor operations) amounted to 3,203 billion, total monetary base creation was — 840 billion, despite the fact that Treasury cash requirements net of security issues to fund debts, which are not important for the purpose of monetary base control, amounted to 17,740 billion, 21.8 per cent higher than the previous year.

Although the Treasury deficit continued to grow at a sustained pace, the methods of coverage differed considerably from previous years and seem likely to produce substantial changes in the structure of public debt. From a breakdown of public sector indebtedness by type and maturity of securities issued and by categories of holders at the end of 1977 compared with the previous four years, one can see that there has been a reduction in the share of the deficit that is financed with monetary base creation, a lengthening of the average life of the debt, a radical change in the distribution of Treasury bills and long-term securities between the Banca d'Italia and banks and that the public is present in large numbers on the market for short-term securities.

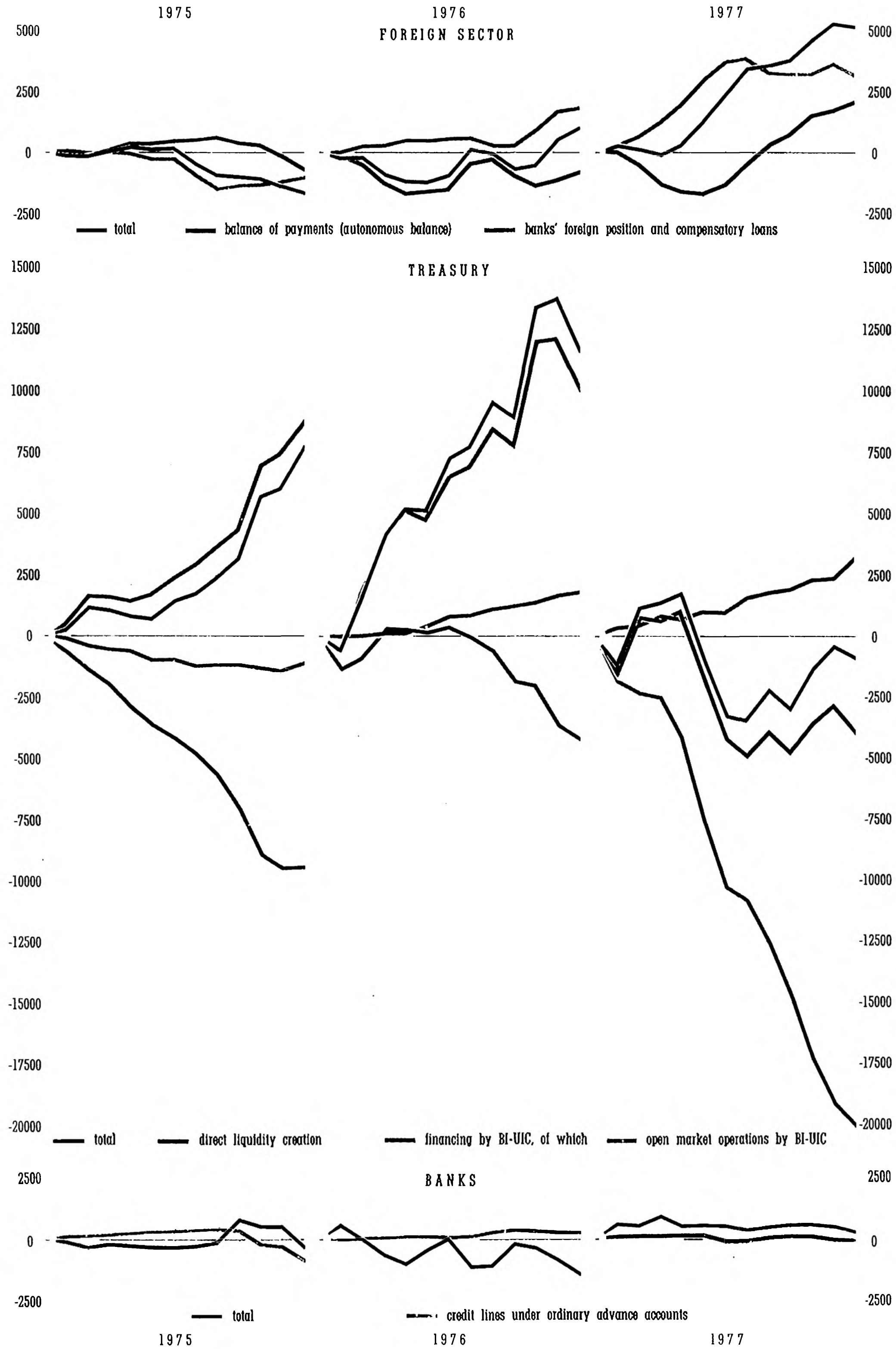
The changed methods of coverage of the cash requirement have not, however, reduced monetary financing of the Treasury, the counterparts of which are the central bank's liabilities and the banks' deposits. In fact the monetary base was principally reabsorbed by increasing the amount of Treasury securities in the banks' portfolios.

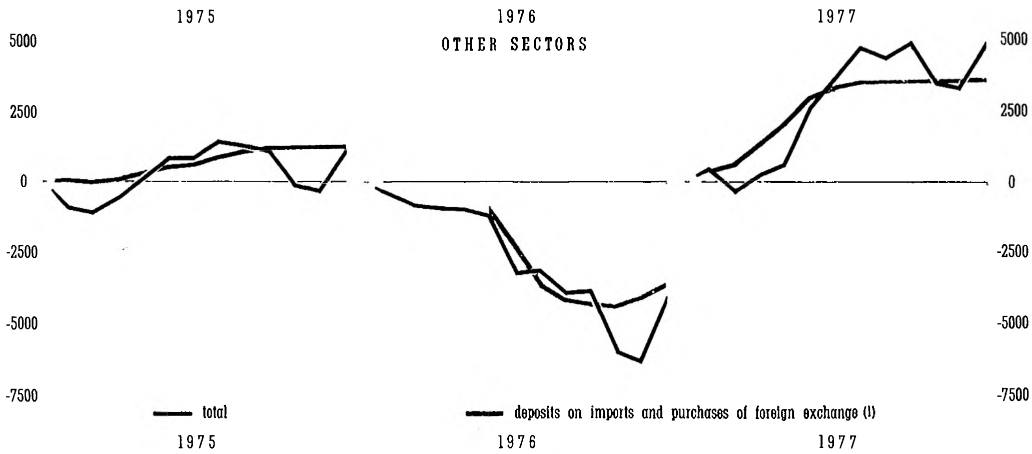
Against a cash requirement net of Post Office savings that rose to 14,604 billion, intervention by the central bank totalled 18,581 billion (Table 25), 15,235 billion of which in Treasury bills. These placements, which exceeded the cash requirement and thus caused a destruction of monetary base, were spread fairly evenly over the first three months of the year and thus made a decisive contribution to the stability of the growth rate of total monetary base. The relative ease with which they were effected was mostly due to the existence of the ceiling on bank lending, although other reasons also emerged at various moments of the period under consideration and helped to make the quantity of placements exceptionally high.

Chart 5

MONETARY BASE CREATION

(cumulative monthly changes, seasonally adjusted data in billions of lire)





(1) Deposit on imports (1975); deposit on currency purchases (1976 and 1977).

Chart 6

USES OF MONETARY BASE

(cumulative monthly changes, seasonally adjusted data in billions of lire)

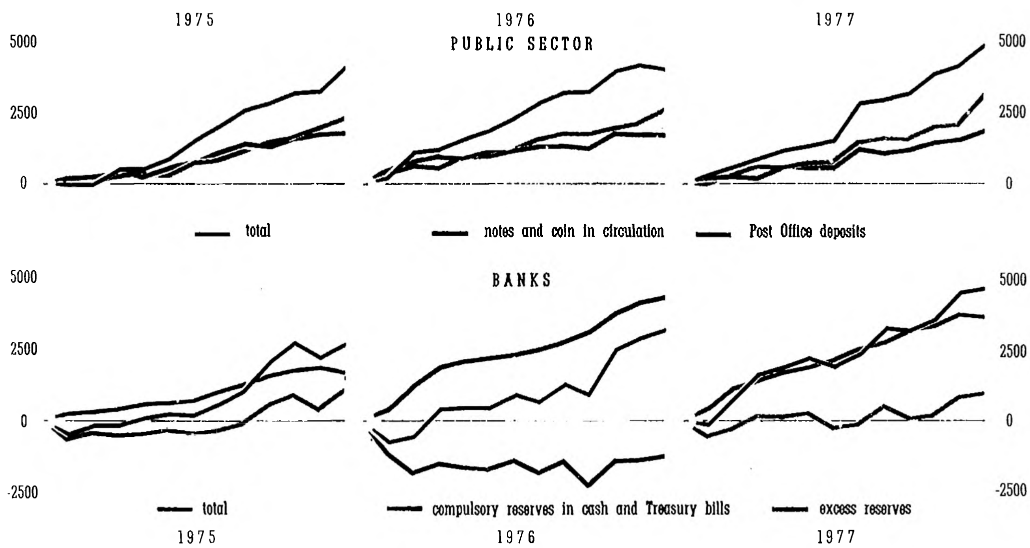


Chart 7

TOTAL MONETARY BASE

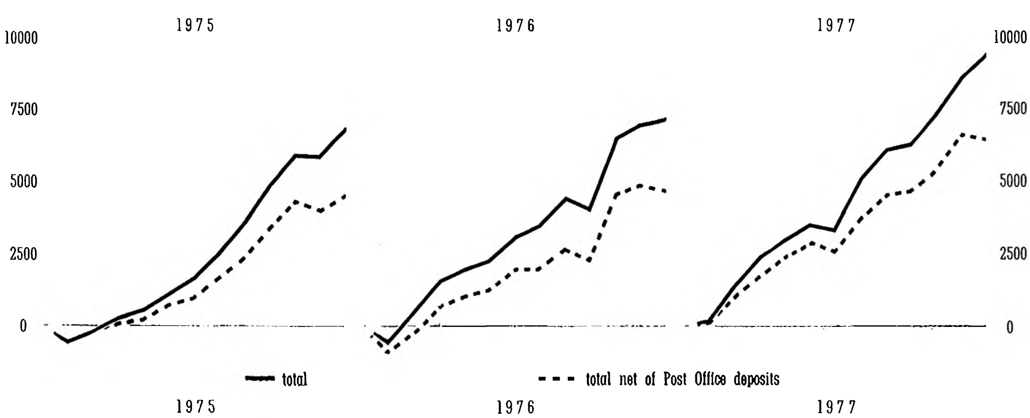


Table 25

TREASURY MONETARY BASE

(changes in billions of lire)

Items	1975	1976	1977				
			Year	Quarters			
				I	II	III	IV
Treasury cash requirements (1)	12,355.5	11,956.0	14,603.9	2,378.7	5,535.3	3,318.4	3,371.5
Interventions (2)	-6,884.7	-2,818.1	-18,580.8	-2,833.3	-9,130.7	-3,606.6	-3,010.2
TOTAL (3) . . .	**5,470.8**	**9,137.9**	**-3,976.9**	**-454.6**	**-3,595.4**	**-288.2**	**361.3**

(1) Net of deposits with the Central Post Office and securities issues to fund loans. – (2) Net of securities issues to fund loans. – (3) Net of deposits with the Central Post Office.

Apart from Post Office savings, which increased by 3,137 billion, the Treasury's direct creation of liquidity over the year was virtually nil (66 billion). This was so because the reimbursement of the last Treasury bills for compulsory reserves was completed during the year, leaving the Treasury with no other direct channels for the creation of monetary base except Treasury notes and coin and other quantitatively unimportant items.

Table 26

TREASURY BILLS FOR FREE INVESTMENT

Date	in circulation	banks and other purchasers					BI–UIC
		at auction	on open market		by banks	by other purchasers (1)	
Amounts at Dec. 1973 . . .	**2,349.3**	....	....	**880.9**	**756.6**	**124.3**	**1,468.4**
Changes: 1974	6,450.0	-732.2	2,360.7	1,628.5	1,483.8	144.7	4,821.5
1975	10,399.7	-2,215.4	7,251.2	5,035.8	4,362.4	673.4	5,363.9
1976	8,556.6	-619.6	2,802.2	2,182.6	-155.9	2,338.5	6,374.0
1977	4,795.4	-2,165.6	17,400.4	15,234.8	10,685.9	4,548.9	-10,439.4
1977 - I qtr. . . .	395.5	451.9	2,266.0	2,717.9	165.5	2,552.4	-2,322.4
II " . . .	3,600.5	1,414.3	7,514.1	8,928.4	6,876.3	2,052.1	-5,327.9
III " . . .	549.1	-1,830.4	3,381.2	1,550.8	532.7	1,018.1	-1,001.7
IV " . . .	250.3	-2,201.4	4,239.1	2,037.7	3,111.4	-1,073.7	-1,787.4
Amounts at Dec. 1977 . . .	**32,551.0**	....	....	**24,962.6**	**17,132.8**	**7,829.8**	**7,588.4**

(1) Including special credit institutions.

Table 27

FIXED-TERM ADVANCES AND DISCOUNTS

Items	1975	1976	1977 Year	1977 Quarters I	II	III	IV
Changes	–1,225.4	0.6	285.3	476.3	–55.5	–419.3	283.8
Averages (1)	*237.3*	*285.9*	*155.3*	*341.7*	*27.2*	*71.3*	*181.0*

(1) Averages of daily figures.

The expansionary trend of the monetary base described earlier, which provided banks with a large volume of liquid funds, greatly reduced recourse to central bank refinancing facilities compared with 1976. Credit granted under ordinary advance accounts did not register any significant variation, while fixed-term advances and, to a small extent, discount operations were only used during March (the daily average for indebtedness was then around 862 billion) when the monetary authorities' squeeze on liquidity proved too severe for some banks, and later in December, when demand for refinancing experienced the usual seasonal increase.

Table 28

OTHER SECTORS' MONETARY BASE

(changes in billions of lire)

Items	1975	1976	1977 Year	1977 Quarters I	II	III	IV
TOTAL	**1,191.8**	**–3,981.1**	**4,971.5**	**1,322.7**	**2,303.9**	**286.6**	**1,058.3**
of which:							
deposits on imports and purchases of foreign exchange (1)	*1,237.3*	*–3,544.6*	*3,544.6*	*1,347.3*	*2,052.3*	*144.9*	*0.1*
compensatory loans . . .	*599.9*	*–650.0*	*639.4*	*60.2*	*175.0*	*121.8*	*282.4*
special credit institutions' deposits	*–649.2*	*252.6*	*104.8*	*469.8*	*–721.1*	*732.7*	*–376.6*

(1) Deposit on imports from May 1974 to October 1975, and deposit on purchases of foreign exchange from May 1976 to October 1977.

The inflow of monetary base from other sectors amounted to 4,972 billion lire, almost entirely due to refunds of the deposit on purchases of foreign exchange (for 3,545 billion) introduced in May 1976. Liquidity creation was concentrated in the first half of the year and more especially in the second quarter when the deposit, which had already been reduced from 40 to 25 per cent on 15th January, was cut to 10 per cent and then on 15th April abolished. The manner in which the expansionary effect of this inflow of monetary base was largely neutralized by open market operations in Treasury bills is discussed earlier on in this chapter.

The central bank's liabilities and the uses of the monetary base

During 1977 notes and coin in circulation increased by 1,850 billion (Table 29) and 13 per cent, which is similar to the previous year's rate (13.5 per cent). The public's demand for notes and coin followed two distinct trends during the year. On the one hand, the ratio of notes and coin to income continued to follow the downward

Table 29

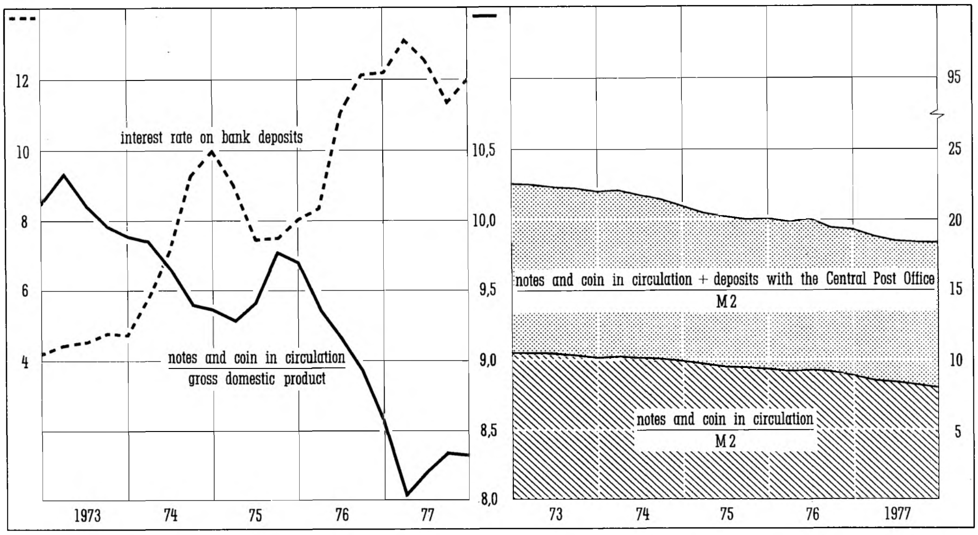
PUBLIC'S MONETARY BASE

(amounts and changes in billions of lire)

Items	Amounts at end-1977	1975	1976	1977				
				Year	Quarters			
					I	II	III	IV
TOTAL	**35,105.4**	**4,123.5**	**4,079.6**	**4,921.7**	**–156.4**	**743.9**	**899.6**	**3,434.6**
of which:								
notes and coin in circulation	*16,075.4*	*1,771.3*	*1,687.0*	*1,849.9*	*–854.7*	*709.0*	*120.3*	*1,875.3*
deposits with the Central Post Office	*19,055.8*	*2,308.8*	*2,605.5*	*3,136.5*	*667.6*	*–52.2*	*490.3*	*2,030.8*

tendency which had first appeared at the beginning of the seventies, a sign that the public is making increasing use of cheques owing to the high interest rates on bank deposits and especially on current accounts. On the other, the more marked variability of this ratio during the year, which closely reflects the trends of interest rates on bank deposits (Chart 8), seems to indicate that households are taking more care over the management of their liquid assets.

Chart 8



Trend of notes and coin in circulation

Unlike the performance of notes and coin, the growth rate of Post Office deposits held to the same level as the previous year (19.7 per cent in 1977 and 19.6 per cent in 1976) even though the yield on these financial assets did not present any change during 1977, with the result that on average for the year the negative differential with the interest rate on deposits widened compared with 1976, whereas that with Treasury bills was still very high (6.9 percentage points). This can be put down to the fact that the flow of Post Office savings, although over 531 billion higher than the year before, turns out to be 8 billion lower if calculated net of interest credited in December, which on average was greater in 1977 than the previous year.

The public's growing preference for bank money was reflected in a higher growth rate of banks' monetary base (23.6 per cent) than total monetary base (18.9 per cent). If the end-December figure for liquidity is adjusted for random growth produced by disinvestments of Treasury bills, estimated at around 400 billion, the annual percentage increase in total reserves appears almost equal to that of compulsory reserves (respectively 21.5 and 21.4 per cent) as well as to that of bank deposits between November 1976 and November 1977 (21 per cent). The similarity of these figures indicates that no impulses of either an expansionary or a restrictive nature were produced by intervention affecting compulsory reserves — unlike the two previous years when these impulses were strong in both directions — and that the growth of liquidity tended to be close to zero.

Table 30

TOTAL BANK RESERVES

(amounts and changes in billions of lire)

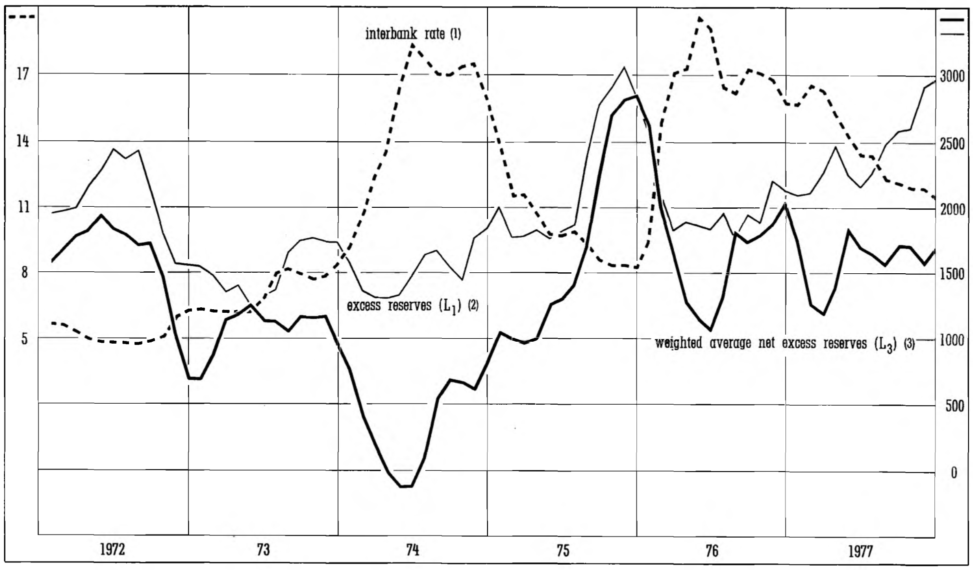
Items	Amounts at end-1977	1975	1976	1977				
				Year	Quarters			
					I	II	III	IV
Compulsory reserves	20,804.0	1,633.7	4,414.8	3,663.8	1,781.8	691.0	508.1	682.9
Excess reserves	3,456.6	1,124.9	−1,116.4	964.0	62.0	−693.4	661.2	934.2
of which:								
deposit with BI-UIC . .	*849.8*	*−174.4*	*−144.3*	*556.9*	*−86.3*	*−53.9*	*99.0*	*598.1*
disposable margin	*1,573.8*	*267.5*	*33.1*	*234.7*	*263.4*	*−705.4*	*646.9*	*29.8*
TOTAL . . .	**24,260.6**	**2,758.6**	**3,298.4**	**4,627.8**	**1,843.8**	**−2.4**	**1,169.3**	**1,617.1**
Excess reserves averages (1)		*2,348.8*	*2,497.4*	*2,406.7*	*2,203.1*	*2,671.3*	*2,281.5*	*2,471.0*

(1) Averages of daily figures.

The absence of any intervention of a special nature affecting compulsory reserves also had the effet of reducing random movements and delays in depositing the reserves which had marked earlier years and hence of raising the actual compulsory reserve coefficient (equal to the ratio of paid-up reserves to the increase in deposits in the previous period) to a value close to the theoretical rate (15.19 and 15.75 per cent).

Also less fitful was the trend of liquidity, its average level during the single quarters being close to that for the year as a whole. The increased stability (Chart 9) was partly due to the fact that interventions affecting the monetary base were carried out under orderly and less tense conditions and partly to the central bank's ability to exert closer control over liquid reserves by means of daily interventions on the short-term securities market and refinancing operations in the form of fixed-term advances.

Chart 9



Excess reserves and interbank rate

(1) Monthly average of weekly data. – (2) Moving average of three data: end-month values. – (3) Moving average of three data: monthly values obtained from an average of daily data; the disposable margin component is weighted for a coefficient below the unit.

Banking

Performance during 1977

During the year bank intermediation was confined within the limits imposed by the coexistence of the ceiling on bank loans and the security investment requirement. By preventing banks from allocating their funds in response to demand, these constraints caused profound alterations in the composition of their balance sheets and in the structure of interest rates. The considerable expansion of deposits in fact contrasted with a very moderate growth in loans, despite a heavy demand by the company sector especially in the first half of the year; this caused a very large increase in the share of assets invested in Treasury bills, the main form of free investment left to banks (Table 31).

Table 31

THE ACTIVITY OF THE BANKS: INDICATORS

Items	1973 (1)	1974 (2)	1975	1976	1977 Year	1977 Quarters (3) I	II	III	IV
	FINANCIAL RATIOS (4)								
Bank credit / Bank reserves (5)	5.2	5.5	5.6	5.7	**5.8**	5.8	5.7	5.9	5.9
Excess reserves / Deposits (6) . . .	2.6	2.1	2.5	1.8	**1.8**	1.7	1.9	1.8	2.0
Bank credit / Total domestic credit .	53.4	56.6	59.0	57.7	**60.0**	58.4	59.7	60.6	61.1
	PERCENTAGE INCREASES (7)								
Bank reserves (5)	18.5	19.4	25.5	10.5	**23.2**	36.7	5.3	25.0	28.0
Deposits	24.1	16.8	25.0	22.0	**23.2**	26.2	16.4	18.4	32.4
Credits	25.4	18.6	24.2	18.8	**24.8**	25.4	37.7	12.3	26.1
Lending (8)	21.1	17.0	17.7	22.7	**15.4**	29.7	9.1	10.8	13.5
Treasury bills	–12.9	206.2	199.8	–5.2	**165.8**	10.7	1,631.7	16.8	122.9
Long-term securities (8)	37.7	15.4	21.8	16.7	**18.9**	20.3	17.2	13.8	23.6
	RATIO TO GROSS DOMESTIC PRODUCT (4) (9)								
Bank credit (6)	69.3	70.1	76.3	73.4	**75.0**	70.1	74.3	76.7	78.4
Lending (6)	48.8	47.4	48.9	47.8	**46.4**	45.1	46.8	47.1	46.7

(1) Excess reserves, deposits and lending are adjusted for random movements at end-1972. – (2) Lending, Treasury bills and long-term securities are adjusted for gaps due to the reform of banking statistics in January 1974. – (3) Quarterly data are seasonally adjusted. – (4) Ratio of average values for the period. – (5) Total bank reserves (excess and compulsory reserves) are adjusted for changes in the compulsory reserve coefficient. – (6) Percentage ratios. – (7) Quarterly rates of increase are calculated as yearly percentage changes. – (8) The funding of hospital and local authorities' debts to the banks are included under lending and not under long-term securities. – (9) The quarterly gross domestic product is on a yearly basis.

The changed composition of credit supply was also reflected in a smaller decline in interest rates on bank deposits than in those on Treasury bills (Chart 10). As regards lending, the only aim of the intervention affecting Treasury bill yields in 1977 was to keep in line with the downward trend of demand for short-term credit so that it

Table 32

BANKS' ASSETS AND LIABILITIES (*)

(amounts and changes in billions of lire)

Items	Amounts at end of 1977	Changes						
		1975	1976			1977		
		Year	Half-year I	Half-year II	Year	Half-year I	Half-year II	Year
ASSETS								
Bank reserves (1)	**23,711.2**	**2,758.6**	**972.3**	**2,326.1**	**3,298.4**	**1,841.4**	**2,786.4**	**4,627.8**
Excess reserves	3,446.4	1,124.9	–1,578.2	461.8	–1,116.4	–631.4	1,595.4	964.0
Compulsory reserves and backing for cashiers' cheques	20,264.8	1,633.7	2,550.5	1,864.3	4,414.8	2,472.8	1,191.0	3,663.8
Credit	**146,501.5**	**19,951.5**	**4,732.2**	**14,521.3**	**19,253.5**	**15,204.7**	**14,539.5**	**29,744.2**
Lending	79,153.5	7,351.8	4,815.0	8,480.4	13,295.4	3,629.0	2,831.7	6,460.7
in foreign currency	*6,573.3*	*–417.2*	*827.8*	*1,348.3*	*2,176.1*	*3,455.2*	*59.0*	*3,514.2*
Treasury bills (2)	17,132.8	4,362.4	–3,753.3	3,597.4	–155.9	7,041.8	3,644.1	10,685.9
Long-term securities (3)	50,215.2	8,237.3	3,670.5	2,443.5	6,114.0	4,533.9	8,063.7	12,597.6
to fund debts	*7,345.8*	*1,789.9*	*89.4*	*88.3*	*177.7*	*324.9*	*3,766.6*	*4,091.5*
Stocks and shares	**1,600.5**	**219.9**	**87.5**	**210.2**	**297.7**	**225.5**	**45.8**	**271.3**
Interbank accounts	**29,446.2**	**5,574.0**	**–4,499.1**	**9,607.9**	**5,108.8**	**–1,705.8**	**6,359.9**	**4,654.1**
Guarantee deposits on behalf of third parties (4)	**58.2**	**13.7**	**55.7**	**2,046.8**	**2,102.5**	**–1,998.1**	**–106.2**	**–2,104.3**
TOTAL...	**201,317.6**	**28,517.7**	**1,348.6**	**28,712.3**	**30,060.9**	**13,567.7**	**23,625.4**	**37,193.1**
LIABILITIES								
Deposits	**152,026.6**	**20,241.5**	**5,658.6**	**16,578.4**	**22,237.0**	**7,866.5**	**20,755.6**	**28,622.1**
Savings deposits	74,146.8	14,998.8	2,924.9	8,249.7	11,174.6	3,887.4	10,005.1	13,892.5
Current accounts	77,879.8	5,242.7	2,733.7	8,328.7	11,062.4	3,979.1	10,750.5	14,729.6
Other deposits	**1,231.0**	**–145.9**	**135.7**	**369.9**	**505.6**	**–168.6**	**–58.2**	**–226.8**
Foreign currency accounts of residents	465.1	–108.1	22.7	117.2	139.9	–71.0	82.0	11.0
Third parties' funds held in trust	765.9	–37.8	113.0	252.7	365.7	–97.6	–140.2	–237.8
Interbank accounts	**28,994.4**	**5,281.2**	**–4,945.6**	**10,209.4**	**5,263.8**	**–1,772.0**	**4,498.5**	**2,726.5**
Special credit institutions' deposits (5)	*4,941.7*	*702.0*	*642.3*	*–119.4*	*522.9*	*107.5*	*–535.0*	*–427.5*
Lending by BI-UIC (1)	**2,552.5**	**–389.0**	**–202.0**	**–1,275.0**	**–1,477.0**	**203.9**	**5.5**	**209.4**
Equity capital	**6,375.9**	**1,416.0**	**731.7**	**300.7**	**1,032.4**	**824.0**	**405.4**	**1,229.4**
Net foreign position (6)	**5,275.4**	**–356.3**	**1,121.2**	**1,013.2**	**2,134.4**	**3,755.7**	**–661.4**	**3,094.3**
Other items	**4,861.8**	**2,470.2**	**–1,151.0**	**1,515.7**	**364.7**	**2,858.2**	**–1,320.0**	**1,538.2**

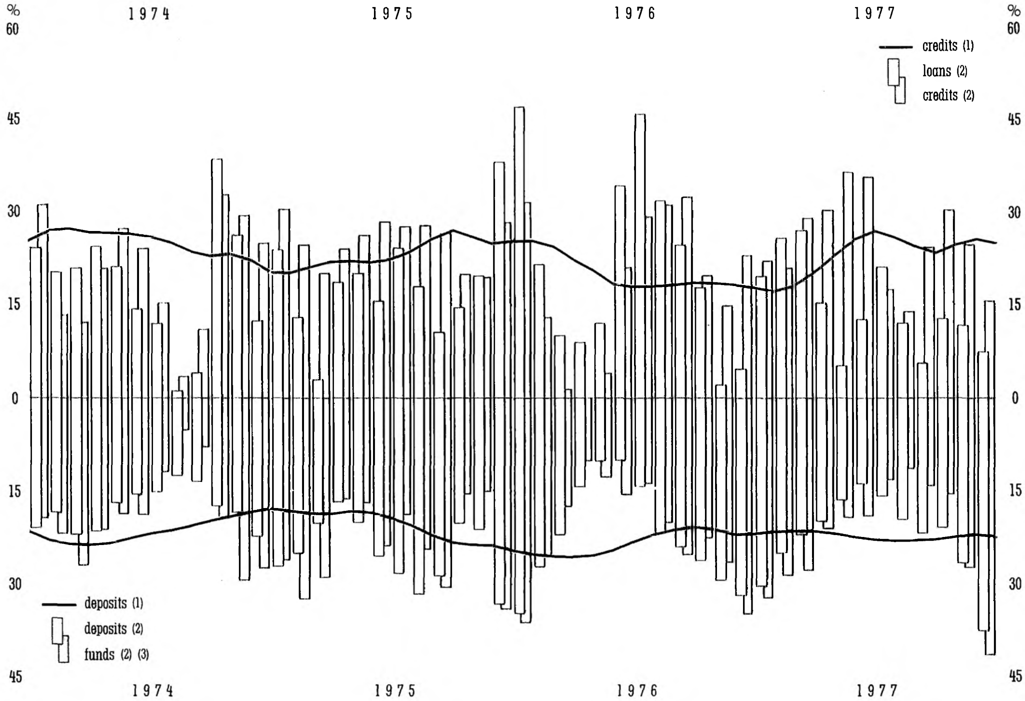
(*) Data contained in this table are calculated in order to assess the flow of funds between banks and other sectors and are made to coincide with data in the corresponding tables in other chapters (Tables 23,26,41). The figures in the other statistical tables on banks do not therefore always correspond with those given here because they are taken directly from the banks' balance sheets or from a homogeneous sample.

(1) The figures used for excess and compulsory reserves and lending by BI-UIC are taken from the consolidated balance sheet of the BI-UIC, which is the statistical source used for calculating the monetary base. – (2) At face value. – (3) Increases in securities portfolios are calculated on the basis of market prices during the year. – (4) From May 1976 and until July 1977 this item includes the compulsory deposit on purchases of foreign exchange paid by the banks with their own funds on behalf of their customers. – (5) Data taken from the special credit institutions' accounts. – (6) The net foreign position of the banks does not coincide with the balance between foreign assets and liabilities owing to the different criteria used when registering relations with "non–residents" in banking and balance-of-payments statistics. Also includes the foreign exchange forming part of the excess reserves.

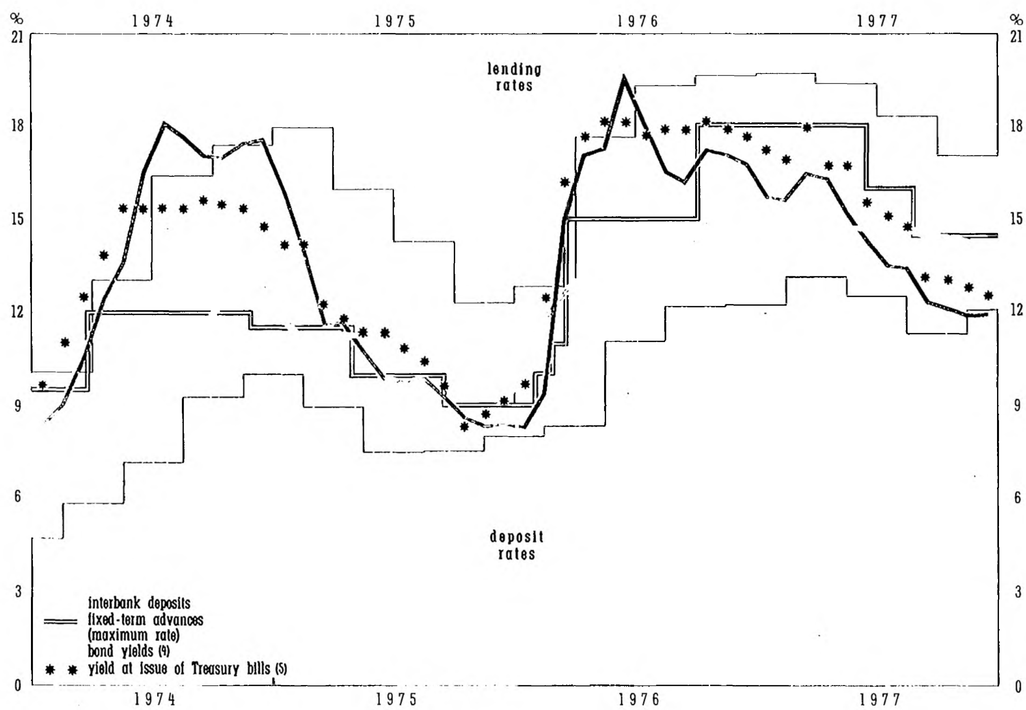
BANKS: BALANCE SHEET ITEMS AND INTEREST RATES

CREDITS AND DEPOSITS

(percentage changes, seasonally adjusted data)



INTEREST RATES



(1) Percentage changes in the 12 months ending in the reference month, calculated from moving averages of three data. – (2) Monthly percentage changes on a yearly basis, calculated from moving averages of three data. – (3) Funds include not only deposits, but also residents' foreign currency accounts, third parties' funds held in trust, deposits of special credit institutions, BI-UIC credits and the net foreign position. – (4) Average yield on bonds issued by industrial credit institutions on the secondary market. – (5) Weighted average of the yields on 3, 6 and 12 month Treasury bills.

would be to the banks' advantage to lend right up to the ceiling; intervention therefore affected principally the interest rates on bank deposits and the public's choice between deposits and Treasury bills.

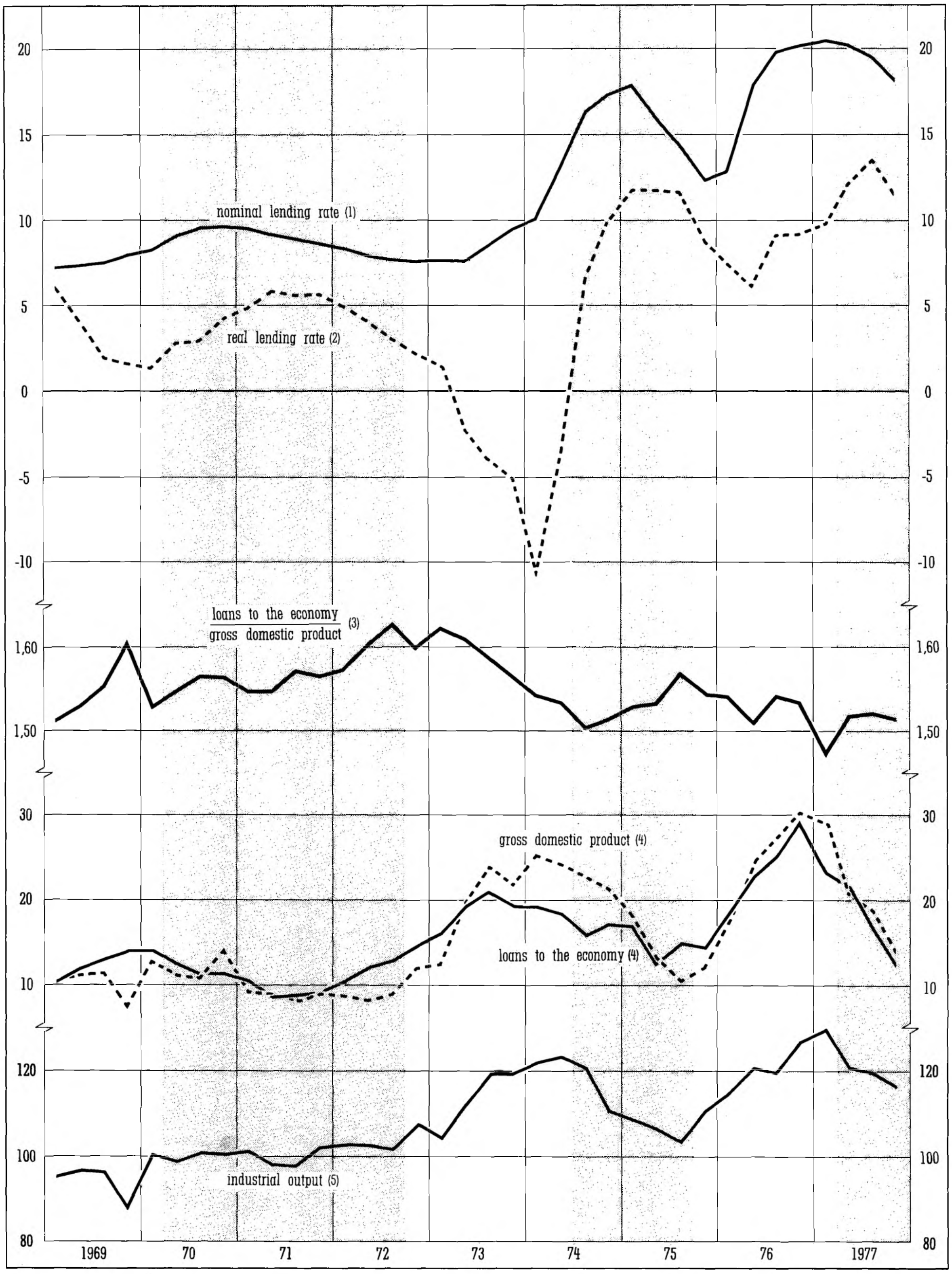
The tendency for banks' total assets to grow more rapidly than total finance, which had been present for several years, became even more marked in 1977 to the point where 81.6 per cent of total domestic credit expansion was intermediated, in one form or another, by the banking system. Bank deposits increased by 23.2 per cent and loans by 24.8 per cent, a gap that is due to the considerable expansion of banks' foreign debtor position (over 3,000 billion during the year; Table 32).

Domestic credit

At the end of 1977 bank loans equalled 52.1 per cent of deposits (58.9 per cent at the end of 1976) and were 8.9 per cent higher than the figure for the end of the previous year. This increase was much smaller than the 18.9 per cent average annual growth during 1973-1976 owing to the funding of a vast amount of loans previously granted to local authorities, to which were added the effects of the ceiling on bank lending and the all but total disappearance of direct bank finance to minor local bodies. These funding operations converted into long-term government securities 4,315 billion worth of loans to municipal and provincial bodies and 406 billion to hospitals; without these operations lending would have increased by 11,181 billion and 15.4 per cent.

The two ceilings on lending introduced in October 1976 and March 1977 differed from those in force between 1973 and 1975 in that they incorporated frequent controls (each month or two months) and so dictated more rigorously the time profile of lending. Both exerted a stronger restrictive effect in the first months of application owing to the need for firmer support of the foreign exchange market (Chart 11). However, leaving aside this period, it is true to say that the ceilings did help to make the growth of bank lending more stable than in previous years (Chart 10) and than the spontaneous tendency that would have developed given the same amount of available reserves, even though

Chart 11



Bank loans and industrial activity

(the shaded areas indicate the periods of stagnation or recession in production)

(1) Average quarterly interest rate on short-term loans in lire amounting to at least 20 million. — (2) Lending rate net of the expected rate of change of wholesale prices in the following six months. — (3) Ratio of the average quarterly value of loans to the quarterly GDP at current prices. — (4) Percentage rates of increase in the 12 months ending in the reference quarter. — (5) Index, 1970=100, of production in mining and quarrying and manufacturing industries, seasonally adjusted.

the volume of loans was not determined entirely without regard for market forces since foreign currency loans were exempt.

Under the stimulus of the ceiling on loans in lire, towards the middle of 1977 foreign currency loans to Italian importers and exporters rose to much higher levels than in the past; the cause was not so much the faster growth rate of funds raised abroad, which rather continued along the trend begun in mid-1975, as the fact that a larger share was invested within the country. Since these funds were unfettered by compulsory reserve or security investment requirements they could be invested in Italy at interest rates which were not only advantageous for firms but also for banks, being higher than those obtainable abroad. The largest increases in foreign currency loans occurred on two separate occasions, at the start and in the middle of the year, coinciding respectively with the peak demand for funds, partly linked to the balance-of-payments deficit, and the period when the ceiling was tightest. Although they could only be used to finance foreign trade, these loans played an important role in keeping the supply of credit to firms flexible.

The other direct control on credit, the security investment requirement, had less effect on the structure of banks' assets in 1977. Of the 11,937 billion net increase in banks' portfolio of long-term securities,

Table 33

BANKS' SECURITY INVESTMENT REQUIREMENT

(percentages ratios between yearly changes)

Ratios to deposits	1974	1975	1976	1977
Required investments:				
at face value	28.35	31.29	33.19	25.53
at purchase price (1)	22.74	26.32	27.42	23.12
Actual investments (2):				
at face value	25.78	33.26	32.30	30.53
at purchase price (1)	20.68	27.98	26.69	27.64
Excess investments / Required investments (3)	–9.04	6.29	–2.65	19.58

(1) Estimated prices of securities issued by industrial credit institutions. – (2) Purchases of securities eligible for the investment requirement. –(3) At face value.

4,092 consisted of securities issued to fund bank loans to public sector bodies, 4,445 other purchases of securities in compliance with the investment requirement and 3,400 free investment. Considering the spread between face value and purchase price of the securities, the ratio of compulsory investments to deposits in 1977 reached one of the lowest levels since the security investment requirement was introduced (Table 33).

During the last four months of the year there was a certain increase in free investment (not in compliance with the security investment requirement), notably in such securities as the two-year Treasury credit certificates and ENEL's indexed bonds which are comparable with Treasury bills as regards yields and degree of liquidity. This recovery was due to the fact that during that period the average interest rate on Treasury bills dropped below that on bonds issued by the special credit institutions: the spread between the two rates, which in March was positive for Treasury bills at 3.04 points, gradually narrowed until September when the sign changed, and by December was negative for 1.39 points (Chart 10).

As in 1975 and 1976, Treasury bills were the main residual item of banks' balance sheets which acted as a cushion between the monetary base creation policy and the growth of loans. However, in 1977 the banks' policy of investment in Treasury bills was profoundly different from that pursued during those years: on the one hand, owing to the ceiling on bank loans these investments were no longer only used as a temporary home for liquid resources but as a real income-earning investment, as the increase in the average life of banks' portfolios shows, while on the other, the competition between bank deposits and Treasury bills was not of secondary importance as it had been in previous years, but affected a large share of financial saving.

During 1977 the banks boosted their intermediation activity on the market for Treasury bills, thus making a decisive contribution towards enabling the public to increase by 4,549 billion its portfolio of Treasury bills, which stood at 3,281 billion at the end of 1976. Although on the demand side, this substantial increase was due to the growing realization that an alternative investment to bank deposits existed, one should not underrate on the supply side the importance of the policy change made by some banks, which in addition to expanding their traditional activities of collecting and investing deposits began to undertake a "pure" form of intermediation that consisted in acquiring large lots of bills at auction to sell them off separately to the public and firms. This trend was particularly evident in the first half of the year, when the high yields on Treasury bills made it extremely onerous for banks to offer competitive interest rates on deposits. At that time the public's investments in Treasury bills were equivalent to over a quarter of the growth of deposits, seasonally adjusted, and to half the Treasury's cash requirement.

However, the number of banks involved in large-scale intermediation with the public on the Treasury bill market was still limited. If the distribution of this activity is assessed according to the amount of Treasury bills which the banks declared they held on behalf of their clients, it appears that in June 1977 three banks alone accounted for 63.8 per cent of the total, that is four times the value of their share of the market for bank deposits at the same date (15.2 per cent). These banks preferred intermediating with the public rather than purchasing Treasury bills for their own portfolios and increasing their deposits. During the twelve months ending in June 1977 their own holdings of Treasury bills grew less than those of other banks, whereas the increase in Treasury bills for " consignment " to their clientele was greater. The improvement in the profit and loss accounts of these banks due to this type of management is underlined by the fact that whereas the gross margin of intermediation of the entire banking system decreased by 0.30 points during the year, in their case it increased by 0.12.

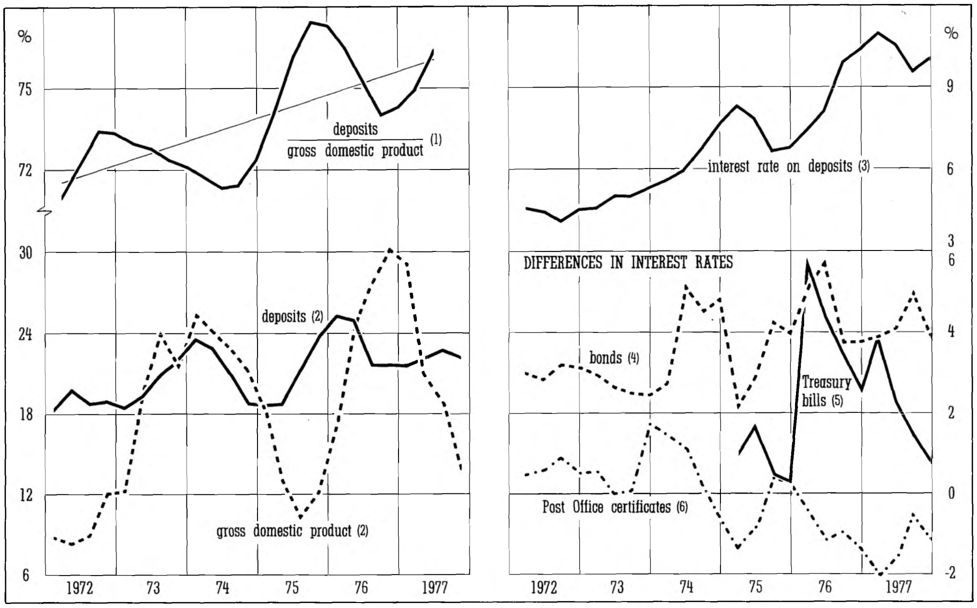
Clients' deposits

During 1977 bank deposits increased by 28,622 billion and 23.2 per cent, against 22,237 billion and 22 per cent the previous year. The growth rate, which in the first half of the year was moderate and lower than at the end of 1976, subsequently accelerated and peaked in December (Chart 10). This trend reflects not only the preferences of the public, but also the course of monetary policy and the performance of the balance of payments which was in surplus from June on.

The ratio of deposits to national income (Chart 12) which had narrowed in 1976 and dropped below the trend line, began to move upward again in 1977. Deposits also recorded a stronger growth than the public's total financial assets, especially liquid ones. The only obstacle to this expansion was the competition of Treasury bills, but this was limited since the public still only held a very small amount.

After the profound changes that had occurred in the early part of the seventies, there was no appreciable shift in the composition of bank deposits between savings deposits and current accounts during 1977, just as there had been none the previous year. Instead, there was a very slight increase in time deposits, which rose from 23,028 billion in December 1976 to 23,950 a year later, though the yield differential between sight and time deposits remained constant. The

Chart 12



Bank deposits and interest rates

(1) Ratio of average total bank deposits to gross domestic product for the 12 months centered on the reference quarter. – (2) Percentage rate of increase in the 12 months ending in the reference quarter. – (3) End-quarter data net of withholding tax. – (4) Average yield on industrial bonds less average interest rate on deposits net of withholding tax. – (5) Average annual yield on Treasury bills sold at auction less the maximum interest rate on bank deposits net of withholding tax. – (6) Yield on interest-bearing Post Office certificates less average interest rate on deposits net of withholding tax.

stability of this type of deposit was due to a sustained increase in time deposits of less than six months and a decrease in those with longer maturities, which together brought the average life of time deposits down from 15.5 to 13.5 months. An explanation for this development can be found not only in the public's greater preference for short-term financial assets, but also in the fact that the competition offered by Treasury bills and, since 1977, also by the two-year Treasury credit certificates mostly affected time deposits with longer maturities. This interpretation is confirmed by the observation that the decrease in the average life of time deposits was more marked for the three banks that expanded most their placements of Treasury bills with the public.

Profit and loss accounts

From the point of view of their profit and loss accounts, although the activity of banks during 1977 was still influenced to a large degree

Table 34

PROFIT AND LOSS ACCOUNTS OF THE BANKS

Items	1971	1972	1973	1974	1975	1976	1977
	billions of lire						
Proceeds (w.r.t. capital assets) (1)	4,367.1	4,858.1	6,429.6	11,624.5	13,975.4	19,098.8	24,548.0
Costs (w.r.t. capital assets) (2)	2,744.1	3,070.0	4,044.8	7,844.4	8,899.4	13,442.6	18,052.1
Other proceeds	630.6	776.6	1,110.4	1,859.7	2,222.7	2,525.7	3,266.4
Personnel costs	1,300.5	1,468.2	1,956.1	2,682.9	3,319.6	4,135.2	4,652.6
General costs	843.8	974.2	1,402.5	2,785.5	3,765.4	3,753.0	4,728.8
Net profit	109.3	122.3	136.6	171.4	213.7	293.7	380.9
	formation of profit as a percentage ratio of deposits						
Gross intermediation margin (3)	3.79	3.52	3.91	5.13	5.71	5.16	4.86
Other proceeds	1.47	1.53	1.82	2.52	2.50	2.31	2.44
Personnel costs	3.04	2.88	3.21	3.64	3.73	3.78	3.48
General costs:	1.97	1.93	2.30	3.78	4.24	3.42	3.54
– depreciation and allowances	*0.71*	*0.66*	*1.16*	*1.58*	*1.97*	*1.73*	*1.63*
of which: devaluation of credits	....	....	....	*0.44*	*0.60*	*0.37*	*0.59*
devaluation of securities	....	....	....	*0.81*	*0.80*	*0.79*	*0.35*
– losses on securities	*0.01*	*0.01*	*0.06*	*0.59*	*0.64*	*0.07*	*0.08*
Net profit	0.25	0.24	0.22	0.23	0.24	0.27	0.28
	other data						
DEPOSITS (billions of lire) (4)	*42,800.8*	*50,895.6*	*61,000.2*	*73,719.4*	*88,925.5*	*109,494.7*	*133,752.7*
NUMBER OF EMPLOYEES	*158,348*	*165,825*	*177,648*	*204,159*	*217,051*	*228,159*	*240,751*
DEPOSITS PER EMPLOYEE (millions of lire)	*270.30*	*306.92*	*343.38*	*361.09*	*409.70*	*479.90*	*555.56*
COST PER EMPLOYEE (millions of lire)	*8.21*	*8.85*	*11.01*	*13.64*	*15.29*	*18.12*	*19.33*
NET PROFIT/ TOTAL ASSETS (as a percentage)	*8.45*	*8.64*	*8.18*	*7.86*	*6.27*	*6.35*	*6.58*

(1) Proceeds from interest-payments, and fees and commissions on domestic and foreign loans, on deposits with the Banca d'Italia and UIC, on securities and investments in partnerships and on interbank accounts and accounts with special credit institutions. – (2) Costs of interest-payments, and fees and commissions on domestic and foreign deposits, advances, rediscounts and swaps and on interbank accounts and accounts with special credit institutions. – (3) Proceeds less costs (regarding only capital assets). – (4) Moving average centered on 5 quarterly data.

by balance sheet structures in disequilibrium after years of inflation and financial difficulties for firms and the public sector, under certain aspects it was less rigid than over the previous two years. The share of staff costs in the balance sheet decreased, the spread between the yield on security investments and the cost of deposits widened, and the difference between the yield from loans and that from securities decreased, albeit slightly.

The gross margin of intermediation, calculated as the ratio of the difference between interest received and interest paid out to the balance-sheet total, narrowed for the second year running, decreasing from 5.2 to 4.9 per cent of deposits (Table 34).

Against a decline in the profit from intermediation activities in the narrow sense, there was an increase, albeit slight, in other revenues which rose, as a percentage of deposits, from 2.31 to 2.44 per cent. The item which contributed most to shaping this trend was transactions in securities, which during 1977 increased principally in response to the rise in placements of Treasury bills with the public.

The structure of bank intermediation in 1973-1977

During this five-year period bank intermediation took place under conditions that were profoundly different from those obtaining in the previous twenty years, on the one hand because of the evolution of the money and financial markets, on the other because of the changes in the general economic situation which led to various administrative measures to regulate banking activities.

The markets on which the banks operate evolved on the whole in the direction of greater competition and more flexible methods of price formation. High interest rates led to more cautious financial management on the part of all operators, the banking system greatly reduced its excess reserves by investing any temporary surplus in Treasury bills, there evolved a money market where changes in interest rates — which are highly sensitive to liquidity conditions — tended to be transferred more rapidly onto bank lending and deposit rates, and finally these rates behaved increasingly less like regulated prices, as evidenced by their greater velocity of adjustment (Chart 10). This evolution was more marked on the liabilities side of banks' balance sheets, where the institutional dissimilarities and the difference in size between the various banks do not appear to have a strong effect and the competition of alternative investments to deposits increased with the public's preference for Treasury bills (Table 35).

Table 35

THE BANKING SYSTEM'S SHARE OF THE SECURITIES MARKET

Type of security	Share of securities in circulation held by the banking system (1)					
	1972	1973	1974	1975	1976	1977
Treasury bills (2)	100.0	85.9	89.3	87.5	66.3	68.6
Government securities (3) .	53.0	50.3	62.6	57.8	55.4	56.6
Bonds	41.2	49.2	58.5	63.1	69.0	73.4

(1) The total of securities in circulation does not include those held by the central bank. Figures refer to 31st. December. — (2) Exluding Treasury bills in compulsory reserves. — (3) Including securities issued by local authorities and bonds issued on behalf of the Treasury.

However, this tendency towards a more market-oriented activity contrasted during the same period with the greater rigidity imposed by administrative credit restrictions. The security investment requirement, in its fifth year in 1977, served to keep the channel of long-term finance open at a time when inflation had driven the public away from bond investment but, by making the banks almost sole purchaser of bonds (Table 35), it allowed the special credit institutions to become totally dependent on them for funds and created a rigid, though still mediated, link between banks and long-term investment finance.

Together the security investment requirement and the ceilings on bank lending gradually reduced the share of commercial loans in banks' assets, drawing the banking system away from its traditional and specific activity and towards the financing of a growing public sector deficit (Table 36). One of the results of this was to weaken the link between the trend of loans to firms and that of deposits and hence of the monetary base, so that in the end it became even more necessary to place direct controls on bank credit.

The ceilings on lending enabled the monetary authorities to control bank loans also over the short run, although under present conditions

Table 36

BANKS: FINANCIAL RATIOS

(Percentage ratios) (1)

Items		Banks and central credit institutions	Savings banks and ICCRI	Total banking system
RATIOS TO DEPOSITS				
Cash and Treasury bills for reserves (2)	1972	19.2	–	13.8
	1977	17.5	6.4	14.4
Tied securities (3)	1972	4.3	17.1	7.9
	1977	21.3	37.3	25.7
Total blocked assets	1972	23.5	17.1	21.7
	1977	38.8	43.7	40.1
Excess reserves	1972	3.8	4.6	4.1
	1977	1.8	1.9	1.9
COMPOSITION OF CREDITS				
Loans (4)	1972	77.9	53.1	69.8
	1977	62.6	51.5	59.2
Treasury bills (4)	1972	0.8	1.9	1.2
	1977	9.1	5.4	8.0
Long-term securities (4)	1972	21.3	44.9	29.0
	1977	28.3	43.1	32.7

(1) Calculated from the average amounts at end-March and end-September. – (2) Including cash to back cashier's cheques. – (3) Including for 1972 securities in compulsory reserves and for 1977 securities in compliance with the investment requirement. – (4) Data for loans in 1972 are adjusted for gaps in series due to the reform of banking statistics after December 1973.

this could have been obtained indirectly simply by producing very large and undesirable increases in interest rates. On the other hand, these ceilings had the disadvantage of freezing the market shares of the individual banks, by weakening competition and reducing the possibility for firms to choose among banks the most convenient source of finance.

Radical changes also occurred in the last five years in the distribution of intermediation between banks. The most salient development was the loss of market shares by the largest banks which was already apparent in the previous five-year period but between 1972 and 1977 took on considerable dimensions. Calculated according to the volume of deposits, the share of the five largest banks dropped from 39.4 to 33 per cent and that of the major and largest savings banks from 28.8 to 27 per cent.

Among the reasons for the difference in the performance of deposits from one bank to another it seems incorrect to assign much importance to the interest rates paid to depositors. For instance, the largest banks where the growth of deposits was decidedly slower than the average for the entire banking system, were also those offering on average the highest interest rates.

An important explanation of the different rates of growth of the banks would instead seem to be the location of their branches, particularly from the point of view of deposits since these are very rarely transferred from one place to another. Not even the largest banks located their branches sufficiently evenly throughout the country to be indifferent to the geographical distribution of deposits which is highly irregular.

The structure of the banking system by branch location and by area of operation is certain to change in the near future when the new national bank branch scheme to open 375 new branches and transfer 50 existing ones is put into effect. Among the criteria behind the scheme, formulated by the CICR (Interministerial Committee for Credit and Saving) in January 1978, was the desire to ensure more even competition in the various areas of the bank market. Consequently permission has been given to open new branches where there is a request and where competition is poor and there is room for development. Authorizations relating to large cities were governed by different criteria, the aim being to adjust the branch network to the volume of activity which, in relation to the number of existing branches, is much higher in these areas than the national average and than the optimum value. The new criteria, which have overridden the principle that several savings or co-operative banks could not coexist in the same town, have also made it possible to approve the requests of some banks wishing to move into new markets outside their traditional area.

The capital market

The outstanding features of the capital market in 1977 were the moderate recovery in the public's demand for bonds in the second part of the year and the large volume of government issues, serving principally to fund the short-term debts of the communes vis-à-vis the banks or taken up directly by the Banca d'Italia. Total net issues were more than twice those of 1976: 22,218 billion compared with 9,422 billion. Net issues of government and other public sector bonds amounted to 15,081 billion (2,570 billion in 1976), the net issues of the special credit institutions to 4,413 billion (compared with 4,163 billion), and those of enterprises and public agencies to 1,286 billion (compared with 992 billion; Table 37).

Table 37

NET ISSUES OF BONDS

(billions of lire)

Items	Amounts at December		Net issues						
			1975 Year	1976			1977		
				half-year		Year	half-year		Year
	1976	1977		I	II		I	II	
ISSUERS									
Public sector	29,466	46,546	5,101	1,985	585	2,570	3,877	11,204	15,081
Special credit institutions	38,750	44,221	5,410	2,548	1,615	4,163	2,465	1,948	4,413
Enterprises and public agencies	10,694	12,090	1,396	611	381	992	639	647	1,286
TOTAL . . .	**78,910**	**102,857**	**11,907**	**5,144**	**2,581**	**7,725**	**6,981**	**13,799**	**20,780**
PURCHASERS									
Banca d'Italia and UIC	14,607	23,274	2,421	887	447	1,334	3,208	4,386	7,594
Banks	42,613	56,753	6,558	3,563	2,610	6,173	4,248	8,200	12,448
Other financial intermediaries . . .	3,829	3,831	819	92	−31	61	−125	122	−3
Enterprises, households and foreign investors	17,861	18,999	2,109	602	−445	157	−350	1,091	741
Shares	*18,500*	*20,000*	*1,357*	*860*	*837*	*1,697*	*849*	*589*	*1,438*

When these issues are calculated net of the part taken up by the Banca d'Italia and of that used to fund the debts of the communes vis-à-vis the banks, one arrives at a value of 9,228 billion which, compared with the corresponding value in 1976 (6,045 billion), enables a more correct assessment to be made of the market's ability to intermediate.

The net issues of the public sector amounted to 15,081 billion (2,570 billion in 1976). Subtracting the part used to fund the communes short-term liabilities vis-à-vis the banks, net issues amounted to 11,123 billion compared with 2,224 billion in 1976. The proportion of total net issues accounted for by the public sector rose from 33 per cent in 1976 to 73 per cent in 1977, a figure which is much higher than any recorded even in the more distant past.

Both cost and debt stability considerations underlay this large volume of issues. The public sector issues taken up by the Banca d'Italia (7,630 billion) were more than counterbalanced by the simultaneous sale of Treasury bills for an amount of 10,439 billion. This policy, while it neutralized the effect on the monetary base of the Bank's purchases, enabled the Treasury to obtain long-term finance in accordance with enabling laws without burdening the capital market with an excessive demand for funds which might have crushed the first signs of recovery.

At the beginning of the year the Treasury issued four-year bonds for a net amount of 810 billion. In order to effect a partial funding of the public debt, it subsequently issued two-year Treasury credit certificates with variable coupons for a total of 5,500 billion. The other main public sector issues consisted of Post Office Savings Fund bonds (3,958 billion), long-term Treasury credit certificates with fixed coupons (4,925 billion) and State Railway bonds (150 billion).

The net funds raised by the special credit institutions recorded a moderate increase, passing from 4,163 billion in 1976 to 4,413 billion. The issues were concentrated in the months when the security investment requirement was checked and especially in March and December. For the whole year the moderate issuing activity of the special credit institutions indirectly reflected the decline in the demand for funds by enterprises which, in turn, was due to the limited expansion of investment and the increased cost of financing.

The large volume of issues at the beginning of the year was linked to the purchase of bonds to satisfy the security investment requirement corresponding to the increase in deposits in December 1976. Subsequently, the decline in issues was offset by the increase in medium and long-term deposits. In December the special credit institutions came back to the market with a large number of issues in view of the rise in lending recorded in the second half of the year and the willingness of banks to make purchases in excess of their compulsory security investment requirements.

Enterprises and public agencies were able to benefit from the more favourable attitude of investors: their net issues amounted to 1,286 billion (compared with 992 billion in 1976) and were concentrated in March, though ENEL also offered two variable coupon loans during the year, adopting the same indexation mechanism as in 1974 and 1976.

Over the year the capital market made a positive contribution to the consolidation of the debt structure of the State enterprises. In fact, while their borrowing from banks expanded moderately, there was a greater increase in their borrowing from the special credit institutions, a larger net issue of bonds, and a larger increase in their endowment funds which the Treasury financed with money raised on the capital market.

Table 38

NET PURCHASES OF BONDS BY TYPE OF INVESTOR

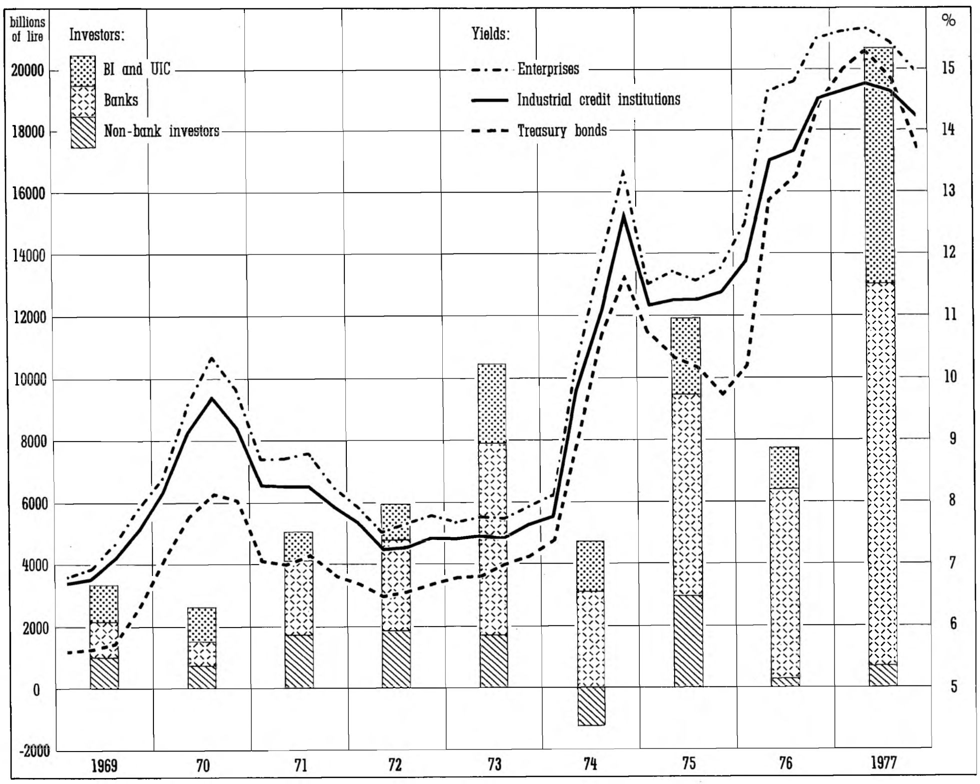
(percentage breakdown)

Investor	1961	Yearly average 1964-73	1974	1975	1976	1977
Banca d'Italia and UIC	3.8	19.7	46.5	20.3	17.3	36.5
Banks	24.5	47.8	89.5	55.1	79.9	59.9
Other financial intermediaries	9.9	3.6	−3.7	6.9	0.8	..
Enterprises, households and foreign investors	61.8	28.9	−32.3	17.7	2.0	3.6
Total ...	100.0	100.0	100.0	100.0	100.0	100.0
Total in billions of lire ...	**931**	**3,930**	**3,473**	**11,907**	**7,725**	**20,780**

Private enterprises also confirmed their renewed interest in the market — linked to the more favourable tax treatment accorded to their bonds, especially when convertible — with net issues rising to 175 billion (compared with 77 billion in 1976 and 17 billion in 1975); 140 of these 175 billion were convertible.

The public (enterprises, households and foreign investors) continued to sell medium and long-term securities in the first few months of 1977 and limited its purchases to Treasury bills since there continued to be widespread uncertainty as to the future course of long-term interest rates and monetary policy remained restrictive. Subsequently, improved yields and expectations together with the issue of the new two-year Treasury credit certificates revived interest in the medium-term sector. The net purchases of the public were larger than in 1976 (741 billion as against 157 billion) so that bonds accounted for a larger proportion of the total flow of financial assets. Nonetheless, in relative terms the public's contribution to the market was still well below the levels of the past (Table 38 and Chart 13).

Chart 13



Bond yields and net issues by type of investor

In January the Treasury issued four-year Treasury bonds for 1,500 billion while redemptions amounted to 532 billion. At the end of the operation the purchases of the public and the banks amounted to 607 billion. In the first quarter the public's net disinvestment of medium-term securities amounted to 434 billion. In June, instead, the reinforcement of more optimistic expectations regarding inflation and the downward movement of yields (sharp in the short-term sector, but still moderate for long-term securities) slowed down the disinvestment of the public which made net purchases amounting to 84 billion in the second quarter. The issues of two-year Treasury credit certificates were well received by the public both because of their intermediate maturity with respect to Treasury bills and long-term bonds, and because of their very high current yield and, finally, in view of the indexation mechanism adopted whereby a minimum coupon is guaranteed which, if necessary, will be increased in line with Treasury bill auction rates.

In the third and fourth quarters the public purchased medium and long-term securities amounting to respectively 581 and 510 billion, thereby showing renewed interest in the capital market after a year and a half of almost uninterrupted disinvestment. Starting in September, in fact, the public ran down its Treasury bill holdings and switched its investments to medium-term securities as well as to bank deposits. The same month saw the second issue of two-year Treasury credit certificates and the public, with a better understanding of the characteristics of these new securities, bought substantial amounts, though these purchases were partially offset by sales of other types of long-term securities.

The purchases of the banks were mainly determined by the security investment requirement. The increase in their portfolios over and above this was related to there being a ceiling on bank lending at the same time as the term structure of yields improved.

Unlike the public, the banks did not modify the term structure of their holdings to any great extent and continued to make large investments in Treasury bills in the second half of the year. In the first part of the year their purchases of medium and long-term securities were concentrated in the months when the security investment requirement was checked, while the other months saw the banks disinvest, mainly by not renewing bonds as they came up for redemption. In August, with the term structure of interest rates improving progressively, the banks returned to the long-term sector, and though their purchases were only moderate this represented a turnaround with respect to the trend of the first half-year. The level of purchases recorded in November and December was due in part to the aforementioned funding of public debt which resulted in the share of total investment accounted for by government bonds rising to nearly 50 per cent (6,183 out of 12,448 billion).

The increase in the purchases made by the Banca d'Italia and the UIC was substantial in both absolute terms (7,594 billion compared with 1,334 billion in 1976) and relative terms (36.5 per cent of total net issues compared with 17.3 per cent; Table 38). The monetary authorities underwrote large amounts in January when a four-year Treasury bond issue was made, and even larger amounts in June and December when Treasury credit certificates were issued. In fact, even under the more favourable conditions prevailing on the market, the change in the maturity preferences of the public and the banks could not result in a large enough increase in the demand for bonds to satisfy the considerable expansion of supply.

The Bank's purchases on the secondary market, which consisted mainly of long-term Treasury bonds and Crediop bonds issued on behalf of the Treasury, were much smaller than in 1976 (16 billion compared with 138 billion) and were concentrated in the first two quarters. The gradual movement of the market towards a more balanced position made it possible to limit interventions in support of prices. In the last quarter the monetary authorities switched to selling so as to check the decline in yields. For the whole year, sales amounted to 66 billion and exceeded purchases, a fact which reflects the aim of encouraging a return to a more balanced interest-rate structure.

Until April medium and long-term security yields continued to follow the upward trend which had started in January 1976. Subsequently, they gradually declined almost without interruption until the early months of 1978. Between December 1975 and April 1977 the average yield on bonds rose from 11.24 to 14.94 per cent. In April 1978 the yield was 13.78 per cent (Table 39).

The yield curve sloped upwards in the second half of the year, reflecting expectations of substantially stable yields. The continued presence of a " hump " for maturities up to four years was due both to the curbing of longer term interest rates brought about by the security

Table 39

AVERAGE ACTUAL YIELD ON FIXED-INTEREST BONDS (1)

Assets	December 1975	December 1976	December 1977	March 1978	Changes between Dec. '76 / Dec. '75	Dec. '77 / Dec. '76	March '78 / Dec. '77
Government bonds	**9.92**	**14.39**	**13.54**	**13.37**	*4.47*	*−0.85*	*−0.17*
Consolidated	5.29	5.80	7.06	7.11	*0.51*	*1.26*	*0.05*
Redeemable	10.88	14.31	15.29	14.55	*3.43*	*0.98*	*−0.74*
Treasury bonds	9.58	14.46	13.35	13.20	*4.88*	*−1.11*	*−0.15*
Other bonds	**11.24**	**14.16**	**14.14**	**13.78**	*2.92*	*−0.02*	*−0.36*
On behalf of Treasury	11.57	13.95	14.33	14.05	*2.38*	*0.38*	*−0.28*
Industrial credit institutions	11.31	14.18	13.98	13.60	*2.87*	*−0.20*	*−0.38*
Real estate credit institutions	9.81	14.31	14.25	13.58	*4.50*	*−0.06*	*−0.67*
ENEL-ENI-IRI	11.36	14.12	13.81	13.62	*2.76*	*−0.31*	*−0.19*
Other companies	11.83	15.14	14.75	14.32	*3.31*	*−0.39*	*−0.43*

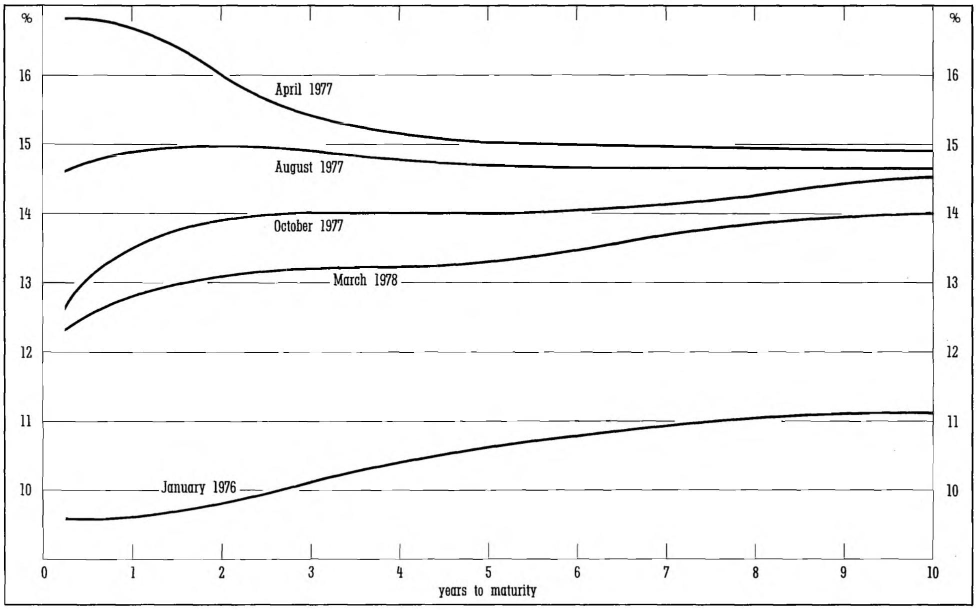
(1) The data have been adjusted to take account of changes made in the series between 1975 and 1976.

investment requirement and to the sale of bonds with average maturities of 2-3 years together with issues of two-year Treasury credit certificates. This particular form of the yield curve makes it clearly advantageous to invest in securities with maturities of 2-4 years and reflects the action of the monetary authorities designed to switch the preference of investors from the short to the medium term (Chart 14).

Over the last few years the large demand for medium and long-term funds coming from enterprises and the public sector (either directly or through the intermediation of the special credit institutions) has not found a ready supply of the same order of magnitude. The action of the authorities has consisted in imposing a constraint on the behaviour of the banks both so as to enlarge the market, and in order to moderate the pressure on interest rates and curb the related additional costs. The secondary effects of the measures taken have been an expansion of the role of financial intermediaries, a narrowing of the direct channel linking savers and borrowers, and an increasing involvement of the Banca d'Italia.

1977 saw the capital market once more unequal to the growing role which the well-known dissociation between saving and investment has imposed upon it. Nonetheless, in the second part of the year the foundations were laid for a return to more efficient working of market mechanisms in the medium and long-term sector, above all through the return to a more balanced term structure of interest rates.

Chart 14



Time/yield curves

Net share issues shrank from 1,697 billion in 1976 to 1,438 billion, thus confirming the inadequacy of the share market as a means to improve enterprises' financial structures which also suffered from the decline in share prices resulting from the worsening of profit prospects. In fact the process of substituting share capital with debt capital continued since the rate of increase of enterprises' indebtedness vis-à-vis the banking system, though it fell to 15.9 per cent from 20.5 per cent in 1976, remained higher than that of share capital financing (7.2 per cent in 1977 compared with 8.6 per cent in 1976).

The increasing difficulty listed companies had in making new issues is reflected in the downward course of rights and in the fall in the ratio of share capital at market value to share capital at par value. At the end of the 1977 stock exchange year this ratio for the shares quoted on the Milan bourse was equal to 1.22 (1.46 in 1976) and to 1.01 if the shares of insurance companies are excluded (Chart 15).

Chart 15

Prices, yields and other share market indicators
(logarithmic scale)

Mention must, however, be made of the action which has been taken to improve the equity market: the completion of the Parliamentary enquiry into Italian bourses, the introduction of a tax credit for those receiving dividends and the regulation of over-the-counter markets. These are the first elements of the reform discussed in previous Reports, which is intended to enable the Italian share market to better evaluate companies' situations — in part by making their balance sheets more transparent — and to increase the scope it offers for intermediation.

The annual survey of the distribution of shares revealed small changes among the various categories of shareholders: the proportion held by the public declined slightly (to 25.3 per cent compared with 26.3 per cent in 1976) with companies making good the difference (52.9 per cent compared with 51.8 per cent in 1976) as they had to underwrite most of the increases in capital owing to the public's lack of interest (Table 40).

Table 40

SHARE CAPITAL BY TYPE OF INVESTOR

(amounts at end-year; percentage breakdown; total in billions of lire)

Investor	Yearly average 1964-73	1974	1975	1976	1977
The public	31.8	21.1	20.4	26.3	25.3
Companies	45.3	51.1	50.0	51.8	52.9
Foreign sector	20.4	20.7	23.2	15.2	15.2
Banking system	0.9	4.4	3.8	4.0	3.7
Other financial intermediaries	1.6	2.7	2.6	2.7	2.9
Total . . .	100.0	100.0	100.0	100.0	100.0
listed	42.6	32.6	30.6	28.9	24.1
unlisted	57.4	67.4	69.4	71.1	75.9
Total share capital at market value	**18,193**	**25,500**	**20,979**	**20,720**	**18,600**

The results of the survey of ten unit trusts showed a substantial decrease in their net assets from 412 billion at the end of 1976 to 348 billion, a decline of 15 per cent. Most of this was due to the fall in the value of their shareholdings from 312 billion at the end of 1976 to 243 billion. The value of their other securities also decreased slightly while their liquid holdings rose.

The reduction in the value of their portfolios mainly concerned their foreign assets and, with the exchange rate essentially stable over the year, reflected both large sales of shares and the poor performance of the U.S. market.

Italian share prices continued the downward trend of the last few years and recorded a further sharp fall over the year with the share index

(1972 = 100) falling from an average of 65.2 in December 1976 to 46.8 in December 1977. This fall of 28.2 per cent (compared with 8.8 per cent in 1976 and 15.5 per cent in 1975) contributed for 67 per cent to the rise in share yields from 3.25 to 5.57 per cent, while the remaining 37 per cent stemmed from the increase in dividends. Turnover on the Milan bourse fell by 28.6 per cent mainly as a result of the decline in share prices but also, though to a lesser extent, because of the contraction in the number of shares traded (Chart 15).

During the first six months of 1977 share prices reflected the weakening of productive activity as well as negative expectations regarding company profits and followed a linear downward trend with slight very short-term fluctuations. The overall level of dividends was higher than the year before though many companies continued to disappoint and this result failed to halt the downward trend in share prices, partly because of the higher dividend tax. In fact, the dividends paid on the same amount of par capital as in previous surveys rose by 23.1 per cent (compared with a fall of 45.2 per cent in 1976) but the withholding tax on dividends was at the rate of 50 per cent as against 30 per cent in 1976.

Towards the end of June there was a turnaround in the trend of share prices but the upward movement soon petered out. The subsequent consolidation during July and the first half of August was followed by a sharp upturn sparked off by expectations regarding the measures to be introduced by the Government on 26th August. The strong upward movement continued after they had been officially announced by the Council of Ministers, and in August alone share prices rose 20 per cent. On 5th September the Consob (the National Commission for Companies and the Stock Exchange) revoked decree no. 32 issued on 14th April 1976 to discourage selling short by requiring sellers to deposit with the Banca d'Italia the securities sold or 90 per cent of their value within three days of the contract.

In the second half of September there was a new turnaround and share prices declined sharply during the last quarter. Since the beginning of 1978, instead, there has been a slight upward movement with the general share index rising 3.4 per cent over the first four months.

The activity of the special credit institutions

In 1977 the special credit institutions were not hampered in their intermediation activities by problems concerning the availability of funds as they had been the previous year. The interest rate policy which brought short-term rates below long-term ones during the year and the constraints still affecting the activities of banks meant that the supply of credit by special institutions was sufficient to meet demand. However, as in 1976 demand was slack owing to the fall-off in investment and the high cost of borrowing.

Outlays totalled 10,616 billion compared with 8,513 in 1976. The increase regarded principally finance for industrial investment and exports, while credit to housing remained stationary (Chart 16).

The increase in credit granted by the special institutions was consistent with the forecasts formulated within the context of total domestic credit expansion: net of repayments, the increase in domestic lending (5,888 billion and 14 per cent, against a forecast of 6,000 billion) was slightly above the moderate growth recorded in 1976 (5,020 billion and 13.5 per cent). Operations on behalf of the Treasury decreased by 249 billion, which indicates that the tendency already present in 1976 to use direct finance to cover the Treasury's cash requirement continued during 1977 (Table 41).

Lending increased moderately in the first half of the year and then picked up more sharply in the second (11.9 per cent on a yearly basis, against 16.1 per cent). The time profile of outlays was similar, although the quarterly performance was more varied with a low in the first quarter and a peak in the last. The decline at the beginning of the year can be ascribed to the considerable amount of activity undertaken by the special credit institutions in the closing months of 1976 encouraged by the introduction of the ceilings on bank credit: since it was in the interest of both banks and borrowers to fund outstanding prefinancing operations in order to leave room for short-term credit, funding operations were brought forward, with a negative effect on outlays by the special institutions in early 1977. It is unlikely that the ceiling had any effect on outlays later in the year, since the demand for bank loans grew only moderately, while the particularly large increase during the last quarter was due not only to seasonal factors but also to the growth of operations at market rates, probably in response to expectations that the cost of long-term credit would remain relatively stable.

Table 41

ASSETS AND LIABILITIES OF THE SPECIAL CREDIT INSTITUTIONS

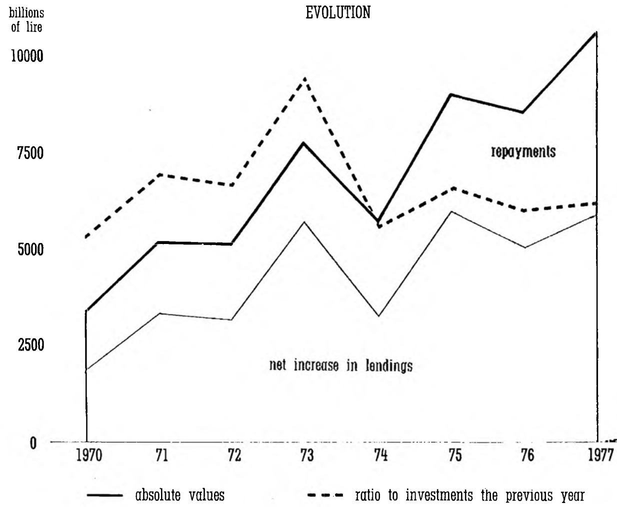
(billions of lire)

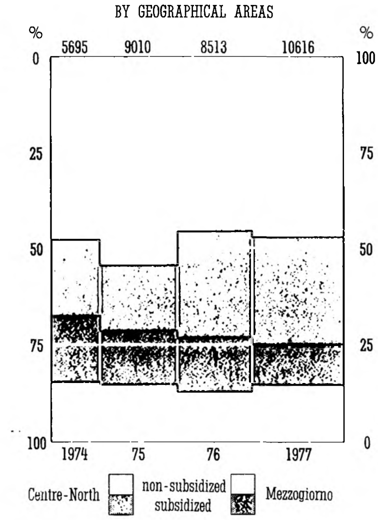
Items	Amounts at end-1977	Changes							
		1975	1976			1977			
			half-year I	half-year II	Year	half-year I	half-year II	Year
ASSETS									
Loans: domestic (1)	48,484	6,072	2,091	2,929	5,020	2,410	3,478	5,888
foreign	2,022	220	270	212	482	217	34	251
on behalf of the Treasury	12,959	2,117	−35	−366	−401	−161	−88	−249
Securities portfolio:	2,067	755	−91	−52	−143	311	296	607
Treasury bills	*1,193*	*665*	*−86*	*−134*	*−220*	*422*	*291*	*713*
Cash and liquid assets	8,038	856	408	−374	34	181	−1,249	−1,068
with: *B.I. in foreign currency* (2) (3)	*3,316*	*−507*	*−26*	*−175*	*−201*	*−173*	*−356*	*−529*
B.I. in lire (2)	*421*	*650*	*−195*	*−56*	*−251*	*251*	*−355*	*−104*
banks	*4,158*	*702*	*642*	*−119*	*523*	*107*	*−535*	*−428*
others	*143*	*11*	*−13*	*−24*	*−37*	*−4*	*−3*	*−7*
Others (4)	3,239	−1,683	374	−251	123	46	249	295
Total . . .	**76,809**	**8,337**	**3,017**	**2,098**	**5,115**	**3,004**	**2,720**	**5,724**
LIABILITIES								
Bonds (5): ordinary	44,225	5,410	2,548	1,615	4,163	2,465	1,948	4,413
on behalf of the Treasury	13,367	1,776	−60	−209	−269	−303	81	−222
Deposits and interest-bearing certificates	5,193	934	22	167	189	484	440	924
Financing by banks	1,562	20	−186	184	−2	−147	330	183
Public funds (6)	3,057	266	243	190	433	44	53	97
Foreign loans (3)	5,406	−400	87	−2	85	−16	−260	−276
Equity capital (7)	3,475	322	348	140	488	458	128	586
Rediscount	524	9	15	13	28	19	..	19

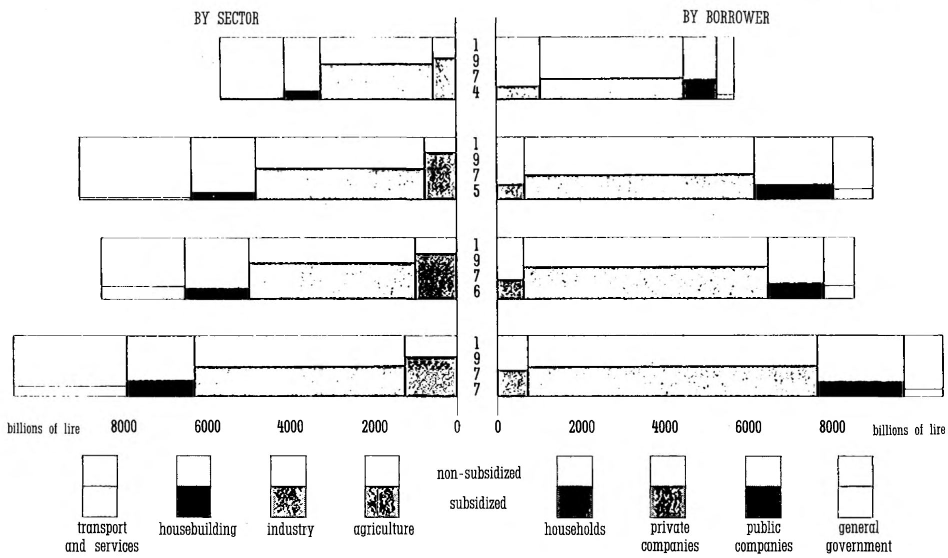
(1) Including financing of compulsory stock-piling. — (2) The total for these deposits, which is calculated from the Banca d'Italia balance sheet, differs from that reported by the institutions chiefly owing to accounting time lags. — (3) For 1976 the changes are adjusted for exchange rate variations. — (4) This balance item is also affected by differences in the items under notes (2), (3) and (5) with respect to those contained in the institutions' balance sheets. — (5) Only in this table are the changes adjusted for spreads between face value and bid value price. Also includes issues by the Mediocredito centrale (medium-term credit institution). — (6) Also includes funds from the regions, the Cassa per il Mezzogiorno (own funds) and the Mediocredito centrale. — (7) Paid up capital and reserves.

OPERATIONS OF THE SPECIAL CREDIT INSTITUTIONS

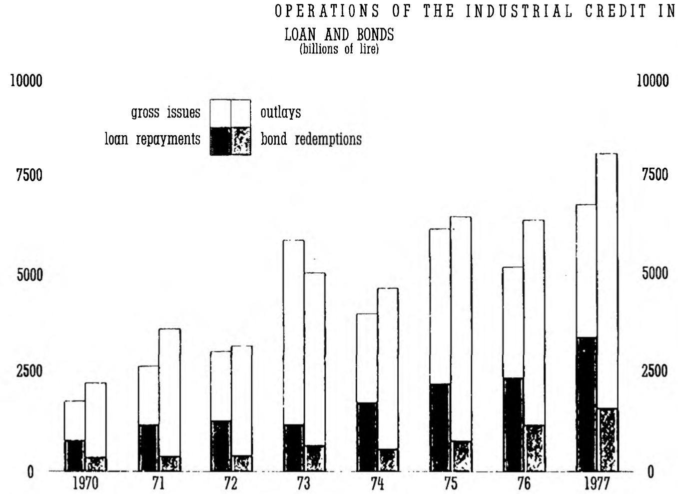
OUTLAYS BY THE SPECIAL CREDIT INSTITUTIONS

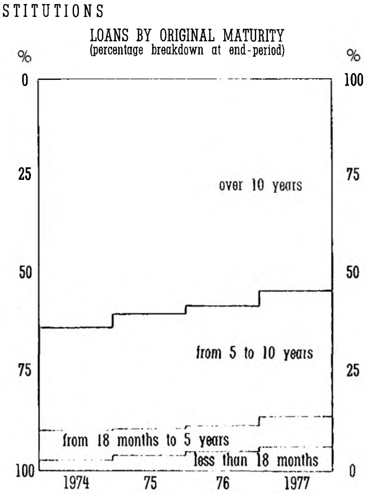






OPERATIONS OF THE INDUSTRIAL CREDIT INSTITUTIONS





Outlays of credit at subsidized interest rates increased less than that at market rates owing to the administrative difficulties encountered in implementing the new system of credit incentives to industry, and in fact it is unlikely that these will have any appreciable effect before the second half of 1978. By contrast both export credit and subsidized loans for investment in housing recorded a satisfactory performance, which in the case of the latter partly offset the depressive effects of high market rates on demand for mortgages.

Funds raised on the bond market (4,413 billion compared with 4,163, net of repayments and placement losses) were provided entirely by bank purchases in compliance with the security investment requirement, since the moderate upturn in spontaneous demand for medium-term securities only concerned those issued by the Treasury and ENEL. In order to stimulate the public's demand for securities issued by the special institutions the current yield was raised by increasing the coupon rate to 12 per cent, and in the first quarter of 1978 permission was given to issue partially indexed mortgage bonds.

The return to a structure of interest rates increasing according to maturity and the weakening of inflation expectations caused an increase in medium-term deposits from 189 billion in 1976 to 924 billion in 1977. This phenomenon was not reserved exclusively to bank purchases in compliance with the security investment requirement as was the case in 1976, but also involved the public who once again found this form of medium-term investment more profitable than bank deposits.

Fund-raising sources

Of the total funds raised by the special credit institutions (7,529 billion against 6,797 in 1976, net of that on behalf of the Treasury) 73.8 per cent (79.4 in 1976) were obtained through bond issues (Table 42). The decline of this source was matched by a considerable increase in deposits and interest-bearing certificates, while the shares of the other fund-raising sources remained more or less stationary. Even among the various categories of institutions placements of securities did not vary much: around 200 billion more than the 1976 flow for those granting credit to public works and 100 billion less for industrial credit institutions.

Table 42

FUND-RAISING SOURCES OF THE SPECIAL CREDIT INSTITUTIONS

(percentage breakdown of changes)

Types of liabilities / Sectors of origin	1975	1976 half-year I	1976 half-year II	1976 Year	1977 half-year I	1977 half-year II	1977 Year
TYPES OF LIABILITIES							
Bonds (1)	78.5	83.9	74.2	79.4	75.8	71.5	73.8
Deposits and interest-bearing certificates	11.4	0.6	5.2	2.8	11.9	12.7	12.3
Mediocredito funds	1.5	1.4	2.4	1.8	–0.1	–0.1	–0.1
Foreign loans (2)	1.3	3.2	5.4	4.2	3.9	2.8	3.3
Equity capital	3.9	9.7	4.4	7.2	11.2	3.7	7.8
Others	3.4	1.2	8.4	4.6	–2.7	9.4	2.9
Total . . .	100.0	100.0	100.0	100.0	100.0	100.0	100.0
SECTORS OF ORIGIN							
The public and companies	13.6	–10.2	–2.4	–6.6	2.1	8.9	5.2
Banca d'Italia and UIC	–0.1	0.9	2.1	1.5	0.5	–0.5	0.1
Banks	74.3	91.4	85.1	88.5	84.4	85.8	85.0
Other credit institutions (3)	5.7	8.4	4.9	6.7	6.9	2.1	4.7
Public sector	5.4	6.2	4.9	5.6	1.1	0.9	1.0
Foreign sector (2)	1.1	3.3	5.4	4.3	5.0	2.8	4.0
Total . . .	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total (in billions of lire)	8,176	3,602	3,195	6,797	4,071	3,458	7,529

(1) Excluding bonds issued on behalf of the Treasury and by the Mediocredito centrale, the value of which decreased by 88 billion in 1977 and by 100 billion in 1976. – (2) Net of compensatory loans held by the Banca d'Italia, which dropped by 529 billion in 1977 and by 207 in 1976. For 1976 the figures exclude exchange rate changes. – (3) Special credit institutions and insurance companies.

Of gross issues of securities (7,700 billion) four-fifths were concentrated during the months when controls were carried out on the banks' investment requirement, providing further evidence of a tendency already present in previous years (two-thirds of the total in 1976). The phenomenon was most marked in March, when securities were placed for a total value of around 2,200 billion owing to the large increase in bank deposits in December 1976. Funds supplied by banks again accounted for most of total funds raised (85 per cent) and were higher than total lending (109 per cent).

Lending

The growth of lending by the special credit institutions (5,872 billion against 5,006, net of loans to finance stock-piling) referred principally to credit to industry owing to the increase in operations at market rates. The share of net lending to Southerm Italy, which had gradually decreased over the previous four years, amounted to 20.8 per cent in 1977 (34.8 per cent in 1974), partly as a result of the delays in putting into effect the new credit incentives under the law for refinancing the Cassa per il Mezzogiorno (Southern Italy Development Fund).

Table 43

DOMESTIC LENDING BY THE SPECIAL CREDIT INSTITUTIONS BY BORROWER

Borrower	Subsidized		Non-subsidized		Total			
	1976	1977	1976	1977	1976	1977	1976	1977
	absolute changes in billions of lire						*percentage changes*	
General Government	**135**	**87**	**458**	**1,030**	**593**	**1,117**	*12.8*	*21.4*
local authorities	12	21	400	592	412	613	*10.8*	*14.9*
other public bodies (1)	123	66	58	438	181	504	*22.9*	*45.4*
Finance and insurance companies	**19**	**33**	**177**	**272**	**196**	**305**	*34.2*	*39.8*
Non-finance companies	**1,914**	**1,867**	**1,977**	**2,101**	**3,891**	**3,968**	*15.6*	*13.7*
public:	266	325	484	892	750	1,217	*9.7*	*14.4*
nationalized	*7*	*9*	*36*	*62*	*43*	*71*	*6.7*	*10.6*
state-controlled	*259*	*316*	*448*	*830*	*707*	*1,146*	*10.0*	*14.7*
private	1,648	1,542	1,493	1,209	3,141	2,751	*18.2*	*13.5*
Households	**150**	**191**	**176**	**291**	**326**	**482**	*4.7*	*6.7*
TOTAL...	**2,218**	**2,178**	**2,788**	**3,694**	**5,006**	**5,872**	*13.5*	*14.0*
public enterprises and bodies	*400*	*412*	*948*	*1,923*	*1,348*	*2,335*	*10.9*	*17.1*
households and private enterprises	*1,818*	*1,766*	*1,840*	*1,771*	*3,658*	*3,537*	*14.8*	*12.5*

(1) Including social security institutions.

The growth in lending largely went in favour of public sector firms and bodies which obtained 2,335 billion worth of credit compared with 1,348 in 1976. The growth rate in this sector rose from 10.9

to 17.1 per cent, while that of the private sector declined (from 14.8 to 12.5 per cent). Specifically, State enterprises, which during 1977 were unable to use the funds allocated under Law no. 675 regarding an increase in their endowment funds, increased their debts to the special credit institutions by 1,146 billion (Table 43).

After a marked shift towards the private sector during the previous year, the flow of credit moved back again towards the public sector (40 per cent against 27 per cent in 1976), a sign that its share is always highly variable (51 and 36 per cent respectively in 1975 and 1974). The drop in the private sector's share of credit during the year did not however affect households which profited from the increase in subsidized mortgages to housebuilding.

Subsidized credit and the cost of medium and long-term finance

Outlays of domestic credit at subsidized rates rose from 3,551 billion in 1976 to 4,107 billion in 1977, although the share of subsidized credit in total lending fell from 42 to 39 per cent owing to the moderate rise in subsidized credit to the agricultural sector and for industrial investment. By contrast export credits increased considerably and the housing sector received almost double the amount of credit subsidies with respect to 1976 (Chart 16 and Table 44).

Industrial investment finance, which decreased from 1,763 billion in 1976 to 1,617 billion in 1977, was badly affected by uncertainties linked to the change-over from the old to the new legislation. In view of the delay in providing the credit incentives granted under Law no. 183 (on subsidized credit to industry) and in implementing Law no. 675 (subsidies for restructuring industry), in the short run the financial support which firms can obtain promptly will basically be confined to the remainder of funds still available under the laws that were abolished and under the " stopgap " measures introduced to overcome administrative difficulties, and which differ from the guidelines originally formulated for the reorganization of the system.

The share of subsidized credit allocated to Southern Italy and the Islands was almost equivalent to the previous year's amount in absolute value but decreased as a ratio to total outlays throughout the country (from 33.7 to 27.8 per cent; Chart 16). This deterioration was larger in the case of finance granted by the industrial credit institutions (from 32.7 to 24.4 per cent) owing to the period of transition before the new laws regulating the activities of the Cassa per il Mezzogiorno become fully effective.

Table 44

DOMESTIC LENDING BY THE SPECIAL CREDIT INSTITUTIONS BY SECTOR

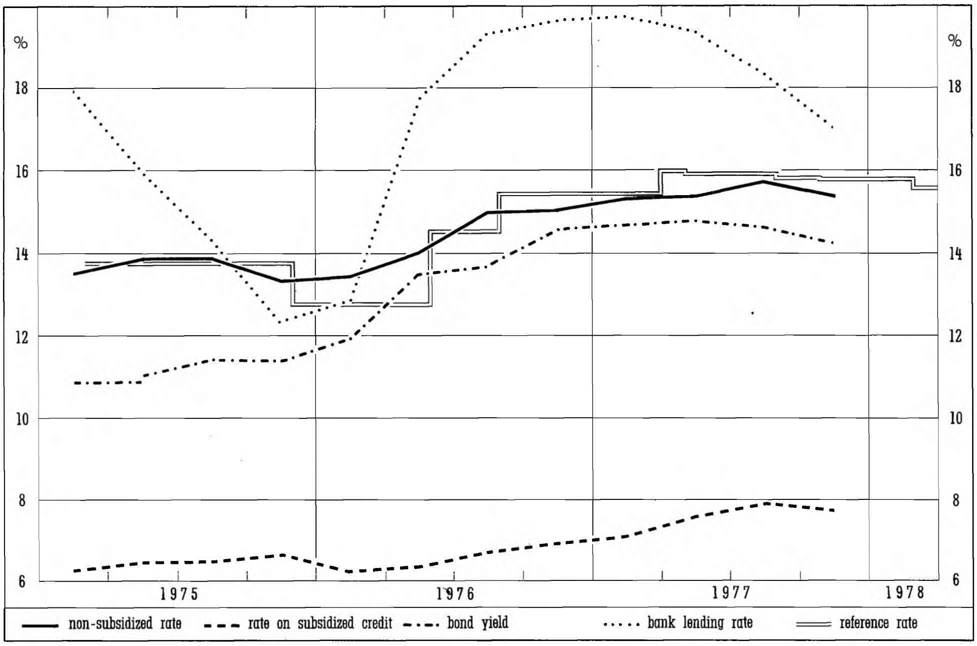
(billions of lire)

Type of credit	Agriculture		Housebuilding		Industry		Transport, commerce and misc. services		Total	
	1976	1977	1976	1977	1976	1977	1976	1977	1976	1977
					Outlays					
Subsidized	728	820	224	413	2,196	2,473	403	401	3,551	4,107
Non-subsidized	252	444	1,370	1,252	1,615	2,567	1,725	2,246	4,962	6,509
TOTAL . . .	980	1,264	1,594	1,665	3,811	5,040	2,128	2,647	8,513	10,616
					Net increases in lending *(absolute values)*					
Subsidized	354	350	194	434	1,364	1,167	306	227	2,218	2,178
Non-subsidized	76	169	909	726	648	1,727	1,155	1,072	2,788	3,694
TOTAL . . .	430	519	1,103	1,160	2,012	2,894	1,461	1,299	5,006	5,872
					(percentage breakdown)					
by region:										
Northern	*52.9*	*51.5*	*48.7*	*39.4*	*52.9*	*49.9*	*63.7*	*71.8*	*55.0*	*52.8*
Central	*21.8*	*23.5*	*30.1*	*38.1*	*17.7*	*29.3*	*16.1*	*10.6*	*20.4*	*26.4*
Southern and islands . .	*25.3*	*25.0*	*21.2*	*22.5*	*29.4*	*20.8*	*20.2*	*17.6*	*24.6*	*20.8*

Unlike private enterprises, public firms and particularly State-controlled ones enjoyed a larger flow of subsidized credit in 1977 than in the previous year. Subsidized loans to households also increased with respect to 1976 (191 against 150 billion) owing to the growth of credit to the housing sector (Table 43 and Chart 16).

The weighted average interest rate on subsidized credit granted by special credit institutions in 1977 was 6.76 per cent. The major reason for the increase with respect to the average for the previous year (5.90 per cent) was the rise in credit to exporters which carried relatively higher interest rates and to the drop in the share of new credit allocated to Southern Italy, where many sectors enjoy particularly advantageous conditions.

Chart 17



Average interest rates applied by industrial credit institutions

The average market cost also rose slightly in 1977 (from 14.72 to 15.42 per cent) although there was a decline in the fourth quarter, mainly owing to the fact that the interest rate offered by industrial credit institutions decreased in response to the fall during the previous quarter in the yield on securities issued to finance the loans (Chart 17).

Credit to industry

Finance granted to industry, net of loans to exporting firms, amounted to 4,184 billion compared with 3,378 billion in 1976, or 41 and 38.6 per cent respectively of industrial investment at current prices. Net of repayments, investment finance increased by 2,428 billion, against 1,862 in 1976.

Investment in industry was predominantly financed at market rates (61.4 per cent of the total against 47.8 per cent in 1976). The decrease in outlays at subsidized interest rates, which continued in the early months of 1978, was particularly marked towards the close of 1977 when the effects of the failure to implement the new credit facilities were added to those produced by the cautious attitude of the main credit institutions in response to the increased financial difficulties of the large chemical companies.

Credit to housebuilding

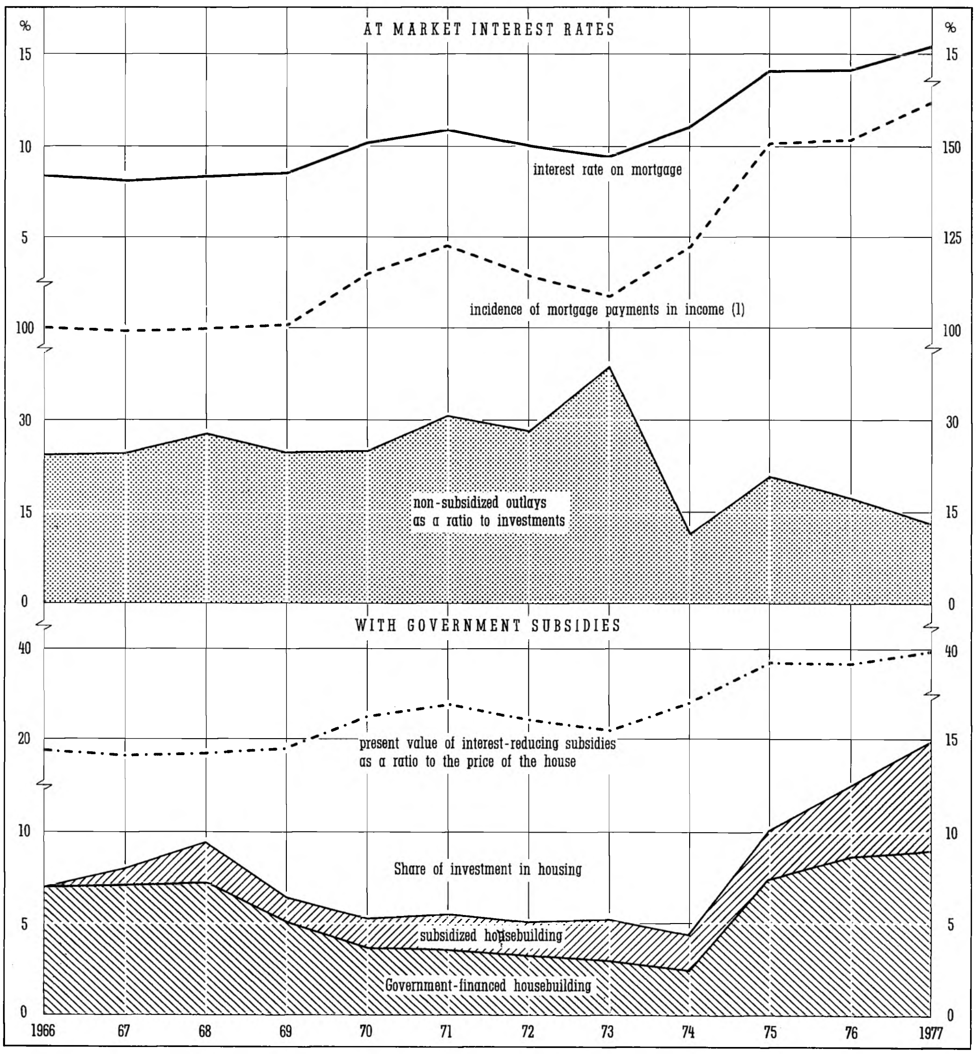
The share of investment in housebuilding financed with long-term credit decreased further in 1977, with the special credit institutions granting loans worth 1,665 billion, or 17.6 per cent of investment expenditure against 1,594 billion and 20 per cent in 1976. This downward tendency had been underway since 1974 when the real-estate credit institutions encountered difficulties in raising funds, although over the last three years it was basically due to the gradual decline in demand. Outlays to housebuilding at market interest rates were modest and amounted to 1,252 billion or 13 per cent of investment, compared with an average of 23.3 per cent in the previous decade (Chart 18).

Despite the policy to keep long-term interest rates down, which was pursued partly by means of the the security investment requirement, they remained high and hence curbed demand for mortgages to finance home purchases. Apart from expectations concerning inflation and income over the long run, the first payments of a mortage at market interest rates have become too heavy for families in the middle-income groups, since over the last ten years they have increased by two-thirds with respect to income. Moreover, it is still difficult for these families to reduce the size of their mortgages because high rates of inflation make it impossible to preserve the real value of their savings for the down-payment.

As regards forms of investment finance, private saving invested in housing remained practically stable in relation to the gross saving of the economy. At the same time the composition of credit between households and firms changed, with the flow of bank loans to firms decreasing as a result of the ceiling on bank lending.

Finance for housebuilding was stimulated by the increase in subsidized credit, which amounted to one-quarter of total outlays (one-seventh in 1976), owing to the effects of the measures adopted in the second half of 1975. Consequently subsidized building accounted for a fairly important share of investment in the sector: taking into account the increase in direct investment by the State, partly and fully subsidized housebuilding represented 15 per cent of total investment in housing (Chart 18).

Chart 18



Financial support to housebuilding

(1) Trend of the share of income absorbed by the repayment of a 25-year mortgage on a house the price of which is a multiple of the borrower's initial income.

In addition to subsidized and Government-financed housing, building undertaken without any State financial support will continue to play a major role. Indexed loans and bonds, eventually accompained by " home-saving " plans, offer a means of channelling a larger share of saving towards investment in this sector.

Credit to agriculture

Finance to the agricultural sector from the whole credit system increased considerably during 1977. Net of stock-pile financing, credit to agriculture increased by 812 billion, at a growth rate of 20.5 per cent (702 billion and 21.3 per cent in 1976; Table 45).

Table 45

LENDING BY THE AGRICULTURAL CREDIT SYSTEM

(changes in billions of lire)

Items	Agricultural special credit institutions		Other institutions		TOTAL	
	1976	1977	1976	1977	1976	1977
Working credit	109	148	206	278	315	426
Improvement credit	311	282	76	104	387	386
Total . . .	**420**	**430**	**282**	**382**	**702**	**812**
Financing of stock-piling system operations	15	16	42	13	57	29
compulsory	*16*	*19*	*31*	*30*	*47*	*49*
voluntary	*–1*	*–3*	*11*	*–17*	*10*	*–20*
Other loans	–2	–	–	–	–2	–
General Total . . .	**433**	**446**	**324**	**395**	**757**	**841**

Working credit in particular showed a very strong increase (426 billion against 315 in 1976), with the result that more financial support was provided to production in this sector: in fact, the ratio of loans outstanding at the end of the year to marketable production (12.9 per cent) was higher than that for the previous year (12.4 per cent). The increase in this type of credit chiefly concerned agricultural bodies and associations and was linked to the extremely large rise in the number of operations at market rates.

Outlays of improvement credit were little over the figure for 1976 (499 against 472 billion) and consequently the ratio of outlays to the value of investment declined further (18.7 per cent against 20.7 per cent in 1976) even though investment did not change in real terms. This type of credit was badly affected by the small number of operations undertaken at subsidized rates. The increase in lending at market rates did little to compensate this situation because borrowers were unwilling to take out long-term loans at market rates in a sector where the return on capital is low.

Credit to exports

Medium-term export credits increased considerably during 1977. Outlays, which benefit from interest-reducing subsidies, totalled 1,554 billion, 50 per cent higher than the previous year's flow (1,047 billion; Table 46). Taking into account the performance of foreign trade, this credit provided greater support to deferred payment exports, representing 4.4 per cent of the total value of goods exported and 17.7 per cent of exports of final capital goods alone (respectively 3.8 and 15.5 per cent in 1976). The share of exports receiving subsidized credit therefore returned to the long-term value after a decline in recent years caused by the paucity of interest-subsidies allocated and the failure to coordinate these grants with the insurance ceiling.

Table 46

EXPORT CREDITS (1)

(billions of lire)

Type of credit	Outlays		Repayments		Net increases		Loans	Financing commit-ments	Applica-tions to examine
	1976	1977	1976	1977	1976	1977			
	flows						*outstanding at end-December 1977*		
Exporters	432.5	855.5	273.2	360.0	159.3	495.5	1,739.7	1,984.2	1,332.8
Financial	614.3	698.2	225.4	420.9	388.9	277.3	1,702.8	2,663.9	397.3
tied	*571.4*	*676.0*	*154.5*	*370.4*	*416.9*	*305.6*	*1,584.7*	*2,606.5*	*362.5*
untied	*42.9*	*22.2*	*70.9*	*50.5*	*–28.0*	*–28.3*	*118.1*	*57.4*	*34.8*
TOTAL ...	**1,046.8**	**1,553.7**	**498.6**	**780.9**	**548.2**	**772.8**	**3,442.5**	**4,648.1**	**1,730.1**

(1) Excluding refinancing and funding by UIC and compensation payments by INA totalling, at end-1977, 1,082 billion (713 at end-1976).

Finance to Italian exporters (supplier credits) totalled 856 billion (433 in 1976) and, unlike the previous year, were higher than outlays for financial credits to foreign countries (698 billion compared with 614 in 1976).

Net of repayments (781 billion) export credits increased by 773 billion (548 billion in 1976), at a growth rate of 29 per cent. If refinancing by the Italian Foreign Exchange Office (UIC) and compensation payments by the National Insurance Institute (INA) are taken into account, net resources transferred abroad to finance exports totalled 1,142 billion.

About half the increase in export credits was used to expand trade with the developing nations, which were final beneficiaries of around three quarters of supplier credits (37 per cent to Algeria alone), which were granted predominantly to Italian engineering and vehicle building firms and construction companies. The increase in financial credits instead went almost entirely to the socialist countries, particularly the Soviet Union and Poland.

Total financing and the formation of financial assets

The more restrictive posture of monetary policy in 1977 was reflected in the fact that total domestic credit expansion (35,850 billion) was at a lower rate than in 1976 (17.8 per cent compared with 19.8 per cent). The rate of expansion was faster in the first few months of the year, slowed down progressively in the middle and then speeded up again in the last quarter (Table 47).

Total domestic credit expansion in 1977 was 5,250 billion above the 30,600 billion target agreed with the EEC in connection with its medium-term support. 1,400 billion of this excess stemmed from the non-State sector and 3,850 billion (3,100 billion net of changes in Post Office current accounts) from the State sector. The overshooting of the target for the non-State sector occurred because the flow of bank lending in the first quarter was underestimated when the figure was agreed with the EEC in April. The overshooting of the State sector target was, instead, concentrated in the fourth quarter and was mainly due to a smaller than forecast increase in tax revenues. In the twelve months to March 1978

Table 47

TOTAL DOMESTIC CREDIT

(changes in billions of lire and percentage growth rates)

Items	1977 I qtr.	1977 II qtr.	1977 III qtr.	1977 IV qtr.	1977 Year	1978 I qtr.	Twelve months ending March 1978
			(changes in billions of lire)				
Cash requirement of the State sector (1)	2,999.9	5,403.4	3,763.6	4,761.4	16,928.3	7,750.0	21,678.4
Financing to the non-State sector (2)	4,451.9	2,809.4	2,761.4	8,899.5	18,922.2	3,100.0	17,570.3
Total domestic credit	7,451.8	8,212.8	6,525.0	13,660.9	35,850.5	10,850.0	39,248.7
of which: the enlarged public sector (3)	....	....	....	....	*21,000.0*	....	....
Limits agreed with the EEC:							
Total domestic credit	6,100	8,200	6,300	10,000	30,600		
of which: the State sector	*8,700*		*3,000*	*1,400*	*13,100*		
the enlarged public sector					*16,450*		
Limits agreed with the IMF:							
Total domestic credit		8,200	6,300	10,000		5,500	30,000
of which: the State sector	*8,700*		*2,500*	*1,900*	*13,100*		
the enlarged public sector					*16,450*		
			(percentage growth rates)				
Cash requirement of the State sector							
in the quarter	4.1	7.1	4.6	5.6		8.7	
in the 12 months ending at end-quarter	23.1	26.3	23.9	23.3		28.7	
Financing to the non-State sector							
in the quarter (4)	4.9	3.0	2.4	3.7		3.4	
in the 12 months ending at end-quarter	16.7	16.4	13.6	14.7		13.2	
Total domestic credit							
in the quarter (4)	4.6	4.5	3.2	4.4		5.4	
in the 12 months ending at end-quarter	18.9	19.9	17.3	17.8		18.8	

(1) The State sector includes the Treasury, Central Post Office Savings Fund and Autonomous Agencies. The cash requirement of the sector is net of Treasury financing to the special credit institutions and of operations to fund the debts of local authorities and health insurance bodies. The cash requirement of the sector, calculated net of Post Office current accounts, amounted to:

2,580.7 | 5,609.4 | 3,538.7 | 4,440.3 | 16,169.1 | 6,530.0 | 20,118.4.

(2) The non-State sector comprises the Economy (households and enterprises) and the public bodies not included in the State sector. Financing to the sector includes the funding operations under note (1). — (3) The enlarged public sector includes the State sector, local authorities, social security institutions, hospitals and ENEL. The cash requirement of the sector also includes an estimate of the increase in the debts of public bodies vis-à-vis suppliers which is not available on a quarterly basis. — (4) Seasonally adjusted data.

— the reference period for the targets agreed with the IMF — total domestic credit expansion rose to 39,250 billion, 9,250 billion above the 30,000 billion target. With the volume of credit available to the private sector limited by the ceiling on bank lending, the overshooting of the target can be attributed to the State sector which, having exceeded its limit in the last quarter for the reason given above, continued to cause credit to expand at a very high rate in the first quarter of 1978.

The performance of total domestic credit in 1977 was considerably influenced by that of foreign currency bank lending which increased by nearly 3,450 billion between January and June, and then remained virtually unchanged in the second part of the year.

The definition of total domestic credit agreed with international organizations includes bank financing in foreign currency so that the expansion of this last is implicitly limited by the targets set for the increase in the broader credit aggregate. Were foreign currency financing not included in total domestic credit, the authorities would control the level of the official reserves but not the overall results of the balance of payments nor, therefore, the total supply of funds to the economy. Furthermore, a smaller than expected increase in foreign currency lending could lead to tighter monetary conditions.

The share of total domestic credit that went to the private sector in 1977 amounted to 18,700 billion (14,400 billion in 1976) when account is taken of the financing provided by the public sector (700 billion as against 300 billion in 1976) and of the change in importers' compulsory deposits with the Banca d'Italia (1,430 billion reimbursed in 1977 compared with deposits of an equal amount in 1976). The cash requirement of the enlarged public sector as defined with international organizations (including, therefore, the increase in the debts of public bodies vis-à-vis suppliers, examined elsewhere in this Report) amounted to 21,000 billion compared with a target of 16,450 billion. The difference is mainly attributable to the performance of the State sector described above.

Total financing provided to domestic sectors (the Economy — households and enterprises — and the public sector), which is obtained by adding share issues, direct foreign financing and a number of minor items to total domestic credit expansion, amounted to 37,272 billion, an increase of 16.5 per cent (34,748 billion and 18.1 per cent in

1976). The ratio of total financing to GDP fell below the already low level recorded in 1976 (28.3 per cent in 1975, 24.2 per cent in 1976 and 21.6 per cent in 1977). When account is taken of the deposit on purchases of foreign currency, the ratio fell from 29.4 per cent in 1975 to 23.2 per cent in 1976 and to 22.4 per cent in 1977 (Table 48).

Table 48

THE ECONOMY'S FINANCIAL ASSETS AND TOTAL FINANCING (1)

(percentages of GDP and rates of increase)

Year	Change in financial assets / GDP	Total financing / GDP	Percentage rates of increase: Financial assets	Liquid assets (M2)	Total financing
1968	17.4	13.7	11.8	12.8	9.7
1969	17.0	14.1	11.7	11.6	10.2
1970	16.6	16.4	11.1	14.0	11.7
1971	20.4	20.5	13.8	16.1	14.5
1972	25.2	23.3	16.8	18.4	16.3
1973	26.2	28.3	17.7	19.9	20.6
1974 (a)	16.4	22.0	11.5	16.7	16.3
(b)	*15.2*	*20.7*	*10.6*		*15.4*
1975 (a)	24.4	28.3	18.1	23.6	20.4
(b)	*25.5*	*29.4*	*19.0*		*21.2*
1976 (a)	21.6	24.2	17.2	21.2	18.1
(b)	*20.6*	*23.2*	*16.3*		*17.4*
1977 (a)	22.5	21.6	18.4	21.9	16.5
(b)	*23.3*	*22.4*	*19.1*		*17.1*

(1) Total financing includes that provided to both the Economy and the public sector. Since 1974 the figures have been calculated gross (a) and net (b) of the changes in compulsory deposits with the Banca d'Italia.

This ratio — calculated using seasonally adjusted data — dropped from 24 per cent in the fourth quarter of 1976 to approximately 23 per cent in the first two quarters of 1977 and then to 17 per cent in the third as a result of the tax measures introduced at the end of 1976 and of the ceiling on bank lending in lire. In the fourth quarter it rose to 20 per cent on account of the spurt in the public sector's cash requirement and the less restrictive effect of the ceiling on bank lending.

The Economy — whose share of total financing fell from 58.4 per cent in 1976 to 54.8 per cent — received 20,443 billion of new funds so that the rate of expansion declined from 16.9 per cent in 1976 to 14.6 per cent. The composition of the financing provided to this sector mainly reflects the limited growth in the amount of short-term funds disbursed by the banks. In fact short-term funds only accounted for 42.2 per cent of the total flow of financial liabilities in 1977 compared with 50.5 per cent in 1976. The bonds issued by enterprises and the loans they contracted with the special credit institutions and the banks resulted in their share of the total flow of funds increasing from 31.3 per cent to 37.1 per cent. Of the other forms of financing, the grants made to the State enterprises by the Treasury passed from 4.1 to 5.7 per cent of the total flow. However, the improvement in the term structure of the new financing was not accompanied by an increase in the proportion of the sector's liabilities accounted for by enterprises' own funds because of the limited growth of profits and the continuing inadequacy of the share market with respect to enterprises' need to rebuild their capital bases.

The course of total financing described above and the current account surplus of 2,014 billion (in 1976 there had been a deficit of 2,343 billion) resulted in the Economy's formation of financial assets amounting to 38,847 billion, an increase of 18.4 per cent (31,092 billion and 17.2 per cent in 1976). The faster growth rate is more marked if the formation of financial assets is considered net of the changes in the compulsory deposit on purchases of foreign currency (19.1 per cent in 1977 compared with 16.3 per cent in 1976). The ratio of the increase in financial assets to gross domestic product also rose slightly from 21.6 per cent in 1976 to 22.5 per cent in 1977 as a result of a fairly limited increase in the first three quarters and a sharp acceleration in the last quarter (Table 49).

When the ratio of the total amount of assets to gross domestic product is considered, the value for the first quarter proved to be the lowest for the whole year, indicating that this was the period during which the Economy's spending power was most limited. Subsequently, the relationship between the sector's available funds and its cash requirement progressively improved. In the second and third quarters the improvement was linked to the fall in production and the better performance of the country's external accounts, while in the last quarter it stemmed from the recovery in the financing provided to domestic sectors (Chart 19). It should, however, be noted that the adjustment in enterprises' liquidity which resulted from this improvement was much slower, and there were still signs of tightness in the second quarter. The slowness of the adjustment was due to the ceiling placed on bank

Table 49

THE ECONOMY'S FINANCIAL ASSETS AND THEIR COUNTER-ITEMS

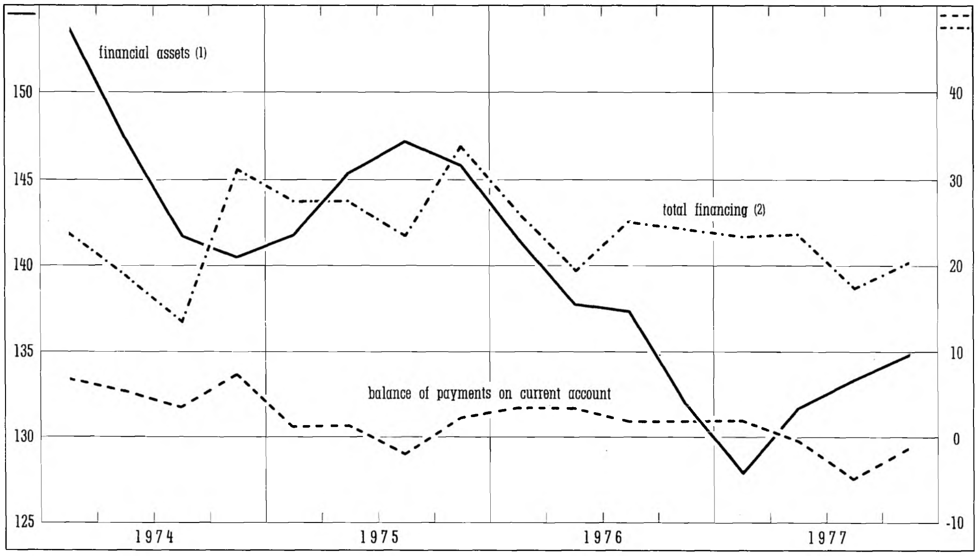
(amounts and flows in billions of lire)

Items	Amounts at end-1976	Flows 1976	Flows 1977 Year	1977 Quarters I	II	III	IV
FINANCIAL ASSETS							
Domestic	197,487	32,925	37,932	4,279	5,632	6,288	21,733
Currency	13,954	1,649	1,827	−789	658	89	1,869
Deposits: Post Office & with Treasury	15,924	2,606	3,137	668	−52	490	2,031
bank	117,872	21,583	27,411	2,692	3,302	4,157	17,260
Treasury bills	2,611	2,371	3,635	2,214	1,870	410	−859
Other deposits and savings certificates	3,702	−51	661	−12	291	26	356
Fixed-interest securities	17,620	169	669	−382	−15	598	468
Shares and equity capital	12,220	1,508	415	95	−41	133	228
Compulsory deposits with B.I. (1)	1,427	1,427	−1,427	−603	−784	−39	−0.1
Other financial assets	12,157	1,663	1,604	396	403	424	381
Foreign	13,816	−1,833	915	808	845	−208	−530
TOTAL...	**211,303**	**31,092**	**38,847**	**5,087**	**6,477**	**6,080**	**21,203**
AGAINST FINANCING OF							
ECONOMY	140,218	20,289	20,443	5,096	3,059	3,009	9,279
Domestic	128,771	20,228	19,182	4,857	2,569	2,658	9,098
Indebtedness to: Banks	61,765	11,437	10,224	2,633	1,090	625	5,876
Special credit institutions	36,047	4,110	4,790	1,071	1,008	1,502	1,209
Bonds	10,220	1,027	1,209	332	223	226	428
Shares and equity capital	11,790	1,788	751	173	150	179	249
Endowment funds	4,520	832	1,167	547	1	4	615
Financing by local authorities	2,048	367	40	10	10	10	10
Other financial liabilities (2)	2,381	667	1,001	91	87	112	711
Foreign	11,447	61	1,261	239	490	351	181
FOREIGN SECTOR (3)	−1,024	−2,343	2,014	−905	299	2,028	592
PUBLIC SECTOR (consolidated) (4)	86,409	14,459	16,829	1,016	6,828	2,382	6,603
UNCLASSIFIED (5)	−14,300	−1,313	−439	−120	−3,709	−1,339	4,729
TOTAL...	**211,303**	**31,092**	**38,847**	**5,087**	**6,477**	**6,080**	**21,203**
ECONOMY'S FINANCIAL SURPLUS OR DEFICIT	**71,085**	**10,803**	**18,404**	**−9**	**3,418**	**3,071**	**11,924**

(1) These deposits are net of the part financed directly by the banks. – (2) These include payments in cash of debts previously contracted by public bodies with suppliers (equal to 231 billion in 1976 and to 659 billion in 1977). – (3) Balance of payments on current account on a transactions basis. – (4) Net of the payments specified in note (2). – (5) Includes discrepancies.

lending which had the effect of introducing a diaphragm between the total supply of financial assets, which depends on the creation of monetary base, and the availability of funds for enterprises which, in the short term, depends on the supply of bank credit.

Chart 19



Total financing provided to domestic sectors and the financial assets of the Economy
(in relation to GDP)

(1) Average quarterly total amounts; seasonally adjusted data. — (2) Quarterly changes; seasonally adjusted data.

The growth pattern of the Economy's financial assets over the last two years was similar to that of the two years 1974-1975, though the fluctuations which occurred were less marked. During the expansion phase of the economic cycle the increase in expenditure on real goods together with faster inflation held down the formation of financial saving in both periods while, after a phase of monetary restriction, the cyclical turnaround and the slowing down of inflation contributed to the adjustment of the financial component of the Economy's portfolio. Furthermore, both towards the end of 1975 and at the turn of 1978 the size of the fluctuation was amplified by swollen Treasury cash requirements. In 1975 the creation of an excess supply of financial instruments helped set the stage for the start of the subsequent inflationary cycle.

As in previous years liquid assets (M2) increased at a faster rate (21.9 per cent) than total assets. This expansion was, however, accompanied by growing interest in forms of financial saving other than bank deposits with substantial purchases of short-term securities (Treasury bills) and, though to a lesser extent, of longer term securities which were made attractive by the introduction of variable coupons (Treasury credit certificates and ENEL bonds). The component of the Economy's financial portfolio to grow the fastest was that consisting of Treasury bills which increased by 3,635 billion compared with 2,371 billion in 1976. Apart from their high yields, the preference for this form of asset was rooted in the high degree of uncertainty reigning in the first part of the year with regard to the future course of both inflation and the quotations of longer term securities. Purchases of Treasury bills were also encouraged by the promotional activity of a number of banks.

The greater accumulation of financial assets was accounted for mainly by households which, faced with continuing economic uncertainty, further increased their propensity to save above the already high level recorded in 1976, as well as the share of this saving invested in financial assets. As for enterprises, the more limited increase in their financial assets reflects the restrictive stance of monetary policy for most of the year. Only towards the end of 1977 did the liquidity of the sector improve and its rate of formation of financial assets increase.

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 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 under-employment, 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.

IV. – THE BANK'S CAPITAL AND RESERVES

Capital.— There were no changes during the year in the amount of the Bank's capital or in the distribution of its shares, which, on December 31st, was as follows:

Shareholders with voting rights:

Savings banks and loan offices	76	with	177,898	shares	and	471	votes
Public-law credit institutions	8	»	54,500	»	»	141	»
Banks of national interest .	3	»	21,000	»	»	54	»
Social insurance funds . . .	1	»	15,000	»	»	34	»
Insurance companies . . .	8	»	31,500	»	»	95	»
	96	with	299,898	shares	and	795	votes

Shareholders without voting rights:

Savings banks and loan offices	13	with	102	shares
Total:	109	with	300,000	shares

Reserves. — During 1977 the reserve funds underwent the following changes:

	Ordinary reserve fund	Extraordinary reserve fund
Amount on December 31, 1976	Lit. 60,088,939,718	Lit. 59,967,934,326
increase:		
– allocation from profits for the year 1976 . .	» 9,057,267,598	» 9,057,267,598
– income received in 1977 from investment and reserves	» 5,176,451,352	» 6,611,979,079
	Lit. 74,322,658,668	Lit. 75,637,181,003

	Ordinary reserve fund		Extraordinary reserve fund	
decrease:				
– distribution to shareholders of a part of the income accruing in the course of 1976 (Article 56 of the Statute) . .	Lit.	82,370,157	Lit.	79,629,843
Amount on December 31, 1977	Lit.	74,240,288,511	Lit.	75,557,551,160

V. – BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

BALANCE SHEET AS

ASSETS

Gold	L.		7,696,885,019,271
Cash	»		332,700,581,121
Domestic bills of exchange:			
discounting for the banks	L.	23,183,260,885	
discount on Treasury bills and coupons	»	—	23,183,260,885
Advances:			
current account	L.	494,750,458,515	
under Treasury decree of September 27, 1974	»	214,487,536,270	
fixed-term	»	278,579,129,600	987,817,124,385
Deferred payment at the clearing system	L.		—
Foreign currency external assets	»		12,925,742,971
Ufficio italiano dei cambi:			
ordinary current account	L.	5,289,778,256,646	
special accounts	»	7,932,702,748,548	13,222,481,005,194
Extraordinary advances to the Treasury	L.		—
Discounting for financing stock-piling	»		1,309,368,068,280
Treasury current account	»		4,795,932,938,676
Miscellaneous services on behalf of the Government - debit balance	»		70,863,458,209
Investment in government or government-guaranteed securities	»		25,434,635,696,421
Treasury credit certificates under Law no. 386 of August 17, 1974	»		432,149,407,890
Investment of reserve funds and other funds set aside:			
government or government-guaranteed securities	L.	709,477,270,638	
other assets	»	275,070,337,316	984,547,607,954
Office buildings	L.		1
Other assets	»		3,500,333,916,412
	L.		58,803,823,827,670
Commitments:			
unused part of credits on advance accounts	L.		1,595,587,919,576
Deposits:			
— guarantee	L.	4,029,236,523,418	
— others	»	27,353,011,154,378	31,382,247,677,796
Securities and other valuables on deposit	L.		351,160,139
Items written off in past years	»		3,152,126,708
TOTAL	L.		91,785,162,711,889

Audited and found correct. – Rome, April 27, 1978

THE AUDITORS

DOMENICO AMODEO
MICHELE BENEDETTI
ALBERTO CAMPOLONGO
ANTONIO CONFALONIERI
GIUSEPPE GUARINO

THE ACCOUNTANT GENERAL

PIETRO SALONICO

EIGHTY - FOURTH YEAR

ƆF DECEMBER 31, 1977

LIABILITIES

Notes in circulation			L.	16,507,726,401,000
Bank drafts and other sight liabilities			»	105,984,627,591
Free deposits on current account			»	875,685,656,430
Tied time deposits on current account			»	1,000,020,000
Special accounts under Law no. 386 of August 17, 1974			»	866,521,222,899
Compulsory deposits on current account:				
compulsory bank reserves	L.	20,411,086,025,285		
others	»	28,640,164		20,411,114,665,449
Foreign currency deposits:				
on behalf of UIC	L.	4,900,241,455,568		
others	»	12,517,368,501		4,912,758,824,069
Foreign lira accounts:				
on behalf of UIC	L.	2,741,049,510,565		
others	»	83,694,323,846		2,824,743,834,411
Ufficio italiano dei cambi - ordinary current account			L.	—
Miscellaneous services on behalf of the Government - credit balance			»	610,790,786,620
Treasury services for various agencies			»	411,956,344,830
Other funds set aside			»	7,895,137,686,882
Other liabilities			»	3,180,353,372,027
Capital	L.	300,000,000		
Ordinary reserves	»	74,240,288,511		
Extraordinary reserves	»	75,557,551,160		150,097,839,671
Net profit for distribution			L.	49,952,545,791
			L.	58,803,823,827,670
Commitments			L.	1,595,587,919,576
Depositors			»	31,382,247,677,796
Securities and other valuables			»	351,160,139
Items written off in past years			»	3,152,126,708
TOTAL			L.	91,785,162,711,889

THE GOVERNOR

PAOLO BAFFI

GENERAL PROFIT

FOR THE

EXPENDITURE

Administration	L.	243,176,391,501	
Emoluments of Directors, etc.	»	489,495,642	
Transport of notes, coin and other valuables	»	1,574,793,015	
Note-printing and note-destruction	»	18,734,296,369	
Computerized data processing	»	19,879,267,126	
Expenditure on premises	»	6,752,428,459	290,606,672,112
Circulation tax on notes and demand drafts	L.	56,611,159,600	
Income and company taxes	»	2,000,000,000	
Sundry taxes	»	3,977,530,640	62,588,690,240
Interest paid out: on the compulsory bank reserve	L.	1,093,039,728,083	
Interest paid out: other	»	3,423,593,707	1,096,463,321,790
Charity and social and cultural aid contributions	»		639,052,597
Depreciation and allowances	»		552,590,853,968
	L.		2,002,888,590,707
Net profit for distribution	»		49,952,545,791
TOTAL	L.		2,052,841,136,498

PROFIT

To ordinary reserves . . . .

To extraordinary reserves . . . .

To shareholders . . . .

To the Treasury . . . .

TOTAL

Audited and found correct. – Rome, April 27, 1978

THE AUDITORS

DOMENICO AMODEO
MICHELE BENEDETTI
ALBERTO CAMPOLONGO
ANTONIO CONFALONIERI
GIUSEPPE GUARINO

THE ACCOUNTANT GENERAL

PIETRO SALONICO

AND LOSS STATEMENT

YEAR 1977

RECEIPTS

Discounts	L.	14,587,209,264	
Interest on advances	»	116,300,051,591	
Interest on accounts with the Treasury	»	68,080,714,020	
Interest on other assets	»	39,017,880,570	
Commissions and other fees	»	11,344,333,480	
Other revenues	»	212,312,419,552	
			461,642,608,477
Interest on Government securities and Crediop bonds issued on behalf of the Treasury: at the rate for compulsory reserves	L.	1,093,039,728,083	
other	»	320,401,566,401	
Interest and premiums on other securities	»	175,229,005,609	
Revenue from real estate	»	2,528,227,928	
			1,591,198,528,021
		TOTAL . . . L.	2,052,841,136,498

DISTRIBUTION

. . . .	L.	9,990,509,158
. . . .	»	9,990,509,158
. . . .	»	30,000,000
. . . .	»	29,941,527,475
. . . .	L.	49,952,545,791

THE GOVERNOR

PAOLO BAFFI

ADMINISTRATION OF THE BANK OF ITALY

AS OF DECEMBER 31, 1977

BOARD OF DIRECTORS

Paolo BAFFI – GOVERNOR AND CHAIRMAN OF THE BOARD

Mario ERCOLANI – DIRECTOR GENERAL

Carlo CIAMPI – DEPUTY DIRECTOR GENERAL

Mario SARCINELLI – DEPUTY DIRECTOR GENERAL AND SECRETARY TO THE BOARD

DIRECTORS

Alessandro BARNABO'
Gaetano CARBONE *
Carlo D'AMELIO
Giovanni Battista DEL BALZO
Danilo de MICHELI
Dario DORIA *
Luigi FALAGUERRA *
Luigi FANTOLA
Giuseppe GIOIA
Lucio MORODER
Remo MORONE
Giovanni Battista PARODI *
Giovanni POGGI

* Member of the Executive Committee.

BOARD OF AUDITORS

Domenico AMODEO
Michele BENEDETTI
Alberto CAMPOLONGO
Antonio CONFALONIERI
Giuseppe GUARINO

ALTERNATE AUDITORS

Luigi GUATRI

CENTRAL ADMINISTRATION

MANAGERS

Tinuccio ROVIDA * – ACCOUNTANT GENERAL
Giuliano MONTERASTELLI – CENTRAL OPERATIONS MANAGER
Giovanni MAGNIFICO – ECONOMIC ADVISER
Pietro SALONICO ** – CENTRAL MANAGER FOR TECHNICAL DEPARTMENTS
Alfredo PERSIANI ACERBO – GENERAL SECRETARY
Rocco QUATTRONE – CENTRAL MANAGER (Milan Branch)
Carmelo OTERI – CENTRAL MANAGER FOR SUPERVISION OF BANKS

* Retired 1.12.1977
** Until 31.12.1977 - Accountant General from 1.12.1977

LIST OF ABBREVIATIONS

BI	Banca d'Italia
BIS	Bank for International Settlements
CICR	Comitato interministeriale per il credito ed il risparmio – Interministerial Committee for Credit and Saving –
CIPI	Comitato interministeriale per il coordinamento della politica industriale – Interministerial Committee for the Co-ordination of Industrial Policy –
Crediop	Consorzio di credito per le opere pubbliche – Credit Consortium for Public Works –
EEC	European Economic Community
EMCF	European Monetary Co-operation Fund
ENEL	Ente nazionale energia elettrica – National Electricity Agency –
EUA	European unit of account
GDP	Gross domestic product
GNP	Gross national product
IMF	International Monetary Fund
INA	Istituto nazionale delle assicurazioni – National Insurance Institute –
INPS	Istituto nazionale della previdenza sociale – National Social Security Institute –
ISCO	Istituto nazionale per lo studio della congiuntura – National Institute for Studies of the Economic Situation –
Istat	Istituto centrale di statistica – Central Institute for Statistics –
NODC	Non-oil developing countries
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
SDR	Special drawing rights
TOE	Tonnes of oil equivalent
UIC	Ufficio italiano dei cambi – Italian Foreign Exchange Office –