BANCA D'ITALIA

ABRIDGED VERSION OF THE

REPORT

FOR THE YEAR

1978

PRESENTED BY THE GOVERNOR TO THE

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31st MAY, 1979

CONCLUDING REMARKS

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III. - THE GOVERNOR'S CONCLUDING REMARKS

The Directorate of the Bank is attending this annual appointment with shareholders and guests at a time when two of its members are facing legal proceedings. The first of these, which were accompanied by the painful and dramatic events with which you are acquainted, were opened on 24th March; two further notices of proceedings have since been served.

Mario Sarcinelli and I are secure in the knowledge that our actions have always been dictated by the interests of the country and those of the Banca d'Italia and by respect for the law. Nonetheless, our position with regard to the Magistrature has left its mark on the Annual Report, particularly this final section, which has been prepared in an atmosphere of profound unease. The presentation has been tailored to the need also to give account of the problems which, in the light of the events that have occurred, now face the country, the credit system and the supervisory authorities.

In July of last year the Director General, Mario Ercolani, left the service of the Banca d'Italia. He had entered the Bank in 1938 and spent three-quarters of his career — before and after the war and a period spent in captivity — in the Research Department, of which he was appointed Head in 1967, distinguishing himself especially by his contributions regarding the Budget, flows of funds in the economy and monetary policy. After his appointment as Central Manager for Foreign Operations in 1970 he presided over events in the foreign exchange field for many years and, in particular, as a member of the Directorate he was subjected to the harsh test of conducting exchange rate policy during the long crisis of 1976-77, in the course of which he confirmed his qualities of strength of mind, understanding of the mechanics of the economy and sound judgement allied with a humanity which over the years has won him the universal affection of bankers both in Italy and at the international level.

The Board of Directors and the Government appointed the Deputy Director General, Carlo Ciampi, to replace him and at the same time filled the vacancy in the Directorate by promoting the Secretary General, Alfredo Persiani Acerbo, to the position of Deputy Director General.

When two years ago I dwelt upon the problems concerning the organization of the Bank and its staff I emphasized my concern at the possible loss of motivation, particularly among those performing the more thankless and arduous tasks in terms of work load and responsibilities, as a result of the tendency to reduce distinctions in the assessment of merit and in remuneration.

This concern is now heightened by the legal uncertainties felt by those who have to act and to take decisions as a result of the recent events I have mentioned as well as other difficult occurrences in the last few years that have affected the interpretation of the functions assigned to the central bank.

Steps must be taken to remove the causes of such uneasiness: the prerequisites of efficient management are peace of mind and the ability to rely on reasonably certain criteria of legitimacy.

The history of the Bank demonstrates that many problems have been overcome as a result of the consensus reached on the basis of a tradition of rectitude in which the interests of the country, the banking system, the community of the Bank as a whole and its individual components are merged.

The certain knowledge that this characteristic is alive within the Bank enables me in these difficult times to reassert my faith in the ability of the staff to carry out its duties in the public interest against a background of constructive internal debate.

In this spirit I wish once again to express the high regard in which the staff is held by the administration of the Bank, addressing myself to all members of the institution but more especially at this time to those entrusted with the task of banking supervision.

The international economy

The causes of instability that have dominated the world stage for the past decade were still active last year both in international relations, in the form of disequilibria in the balance of payments of the main industrialized countries and fluctuations in the terms of trade, and in domestic economic performance, in the shape of the persistence of inflation and unemployment.

During 1978 as a whole the considerable stability of primary product prices and the resultant improvement in the terms of trade of OECD countries contributed to the slight slowdown in the rate of inflation and the total elimination of the area's current account deficit, which had exceeded 25 billion dollars in 1977.

The rise in raw materials prices resumed, however, and in the last few months of the year it was already apparent that the positive results achieved by the industrialized economies on the inflation front and in the balance of payments were only temporary. The main countries entered the expansionary phase of the business cycle simultaneously and international liquidity was created in abundance by the balance-of-payments deficit of the United States. These economic and monetary factors combined with political tensions in the Middle East and South East Asia to exert fresh upward pressure on the prices of raw materials and petroleum.

In the present situation, in which prices are set predominantly in conditions of oligopoly and some raw materials are potentially in short supply, the attempts on the part of the more highly industrialized countries to shift the terms of trade back towards the levels prevailing before 1973 are thwarted on the one hand by the direct reactions of the countries exporting these materials and on the other by the working of the markets; beyond the short term the effects of conflicts over the distribution of wealth are both inflationary and recessionary for the world economy as a whole and are the more acute the greater are the tensions within each country. These effects have emerged with greatest severity in the economies of western countries, where the spurious inflation element in the nominal growth of national income now outweighs the reduced component representing real growth.

An increase in the proportion of total resources allocated to investment and a sectoral distribution of investment in which greater regard is paid to the changes that have occurred in recent years, both in the relative prices of goods and factors of production and in the direction taken by the international division of labour, remain necessary but not sufficient conditions for correcting this situation, which is deceptive as far as growth is concerned and above all humiliating if one considers the degree of control over inflation achieved at other times and in other countries.

The weakness of investment activity is having an adverse effect on the rise in productivity, which is proving to be an important weapon in the fight against inflation, as wages growth remains generally high (although varying from one country to another), responds poorly to changes in the relation between the supply of and demand for labour and cannot easily be controlled by means of incomes policy or by setting money supply growth targets.

Last year the increase in fixed capital formation in the OECD area as a whole was only slightly higher than that in national income, so that the rise in the ratio between these two variables offset only a small part of the large decline of more than two percentage points that had occurred between 1974 and 1976. In a number of countries the profit margins and financial situation of companies have improved, the degree of capacity utilization has increased and interest rates have remained relatively low after taking expectations of inflation into account. The fact that capital formation is barely expanding in spite of such progress is due to continuing rigidity in the deployment of the labour force and uncertainty caused partly by exchange rate instability, itself stemming largely from the accentuation of the current payments imbalances among the main OECD countries.

In particular, there has been an increase in the current account deficit of the United States and in the surpluses of Japan and the Federal Republic of Germany. Signs of progress in the adjustment process did not appear until the second half of the year when, as had been hoped, the Federal Republic of Germany, Japan and the other major industrialized countries began to take over the role hitherto played by the United States in sustaining economic activity and world trade.

Recent monetary developments at the international level confirm the analysis made in last year's Report, namely that management of exchange rates should be accompanied by appropriate domestic economic measures. It would be even more effective if it were combined with concertation among the various countries aimed at defining desirable, or at least acceptable and sustainable, current account surpluses and deficits in order to avoid the formation of areas of stagnation that would have a deflationary effect on the world as a whole.

The fall of the dollar was checked by the measures announced by the US Administration on 1st November. They mark a turning point in the exchange rate policy of the United States, which is resorting for the first time to direct intervention on a substantial scale based, moreover, on the creation of debts in foreign currencies rather than in dollars and accompanied by rigorous monetary measures and the prospect of fiscal changes.

Against the background of renewed cooperation in the management of exchange rates, measures have been introduced and studies carried out in order to forestall the risk of an uncontrolled diversification of official reserves. The central banks have reactivated their agreement limiting the reinvestment of reserves in the euro-currency markets and interest has revived in the creation of a "substitution account" at the IMF for the partial and voluntary conversion of dollar reserves into special drawing rights.

The recent European monetary agreements also correspond to the desire to limit and manage the flexibility of exchange rates by linking it with substantial financial support without, however, introducing rigid requirements which would hamper free trade and distort the international allocation of resources on account of the differences among rates of domestically induced inflation.

The consensus reached with regard to these fundamental questions derives from the experience of floating exchange rates gathered in the last five years as well as that of the twenties and thirties. This has confirmed that private speculation does not fulfil the stabilizing role ascribed to it by the advocates of freely floating rates; it is even less able to do so in the situation brought about by the oil crisis, in which it has not been possible to move towards stable equilibrium, with surpluses or balance in the current accounts of the industrialized countries. Balance-of-payments disequilibria, even those of a temporary, reversible nature, have often been exacerbated, giving rise to the only partly symmetrical phenomenon of "vicious" and "virtuous" circles.

The need for international reserves with which to meet intervention requirements and to maintain exchange rates on a path consistent with the forces governing them in the medium term has not disappeared. Since 1973 the practice of compensatory financing has added to the international liquidity deriving from traditional sources. "Settlement" has often been made by increasing official liabilities rather than reducing assets. Hence the growth in gross reserves could not serve as an unambiguous measure of the expansionary forces stemming from the process of international monetary creation, in which a distinction must be made between gross and net liquidity.

The changes in real exchange rates that have occurred in the last six years show that the exchange rate can play a not inconsiderable role in the process of structural adjustment, even in open, highly indexed economies. The more highly industrialized economies, in which the control levers cannot be used freely or, in some cases, at all, require the room for manoeuvre that such flexibility in exchange rate relationships implies. An exchange rate mechanism incapable of adapting to movements in real costs would entail the risk that adjustment would be sought by restricting the openness of the economy, particularly as far as capital flows are concerned, thus reducing the level of integration among the economies in question; such integration must be promoted by means of policies of regional development and be measured primarily in terms of the freedom to carry out transactions and only as a means to that end in terms of exchange rate certainty.

A further reason for economic convergence is that the creation of a regional entity may lead to the formation of blocs, which has caused considerable damage in the past, particularly in Europe. There would be no justification for running such a risk unless the regional group achieved true, active cohesion.

The idea of establishing the European Monetary System was conceived at the Bremen summit as a fundamental component in a renewed drive towards European economic and financial integration; greater monetary and exchange rate stability was to be pursued as part of joint action to speed up growth, reduce unemployment and inflation and strengthen the less prosperous economies of the Community.

Along the way the initial inspiration seemed to wane. The Italian position adopted in the multilateral bodies and bilateral meetings in which the characteristics of the EMS were laid down remained more faithful than those of other countries to the aim of creating a system to which all member countries could belong and which could reduce not only the dangers of inflation but also the risk of deflation. Accordingly, it was stressed that reciprocal exchange rate obligations, based on the principle of truly symmetrical economic adjustment, should be accompanied on the one hand by financial support arrangements to resist speculative attacks and on the other by substantial aid for the less strong countries in order to check and then eliminate the perverse effects of the present redistribution of resources through the Community budget.

The agreements that came into force on 13th March provide for a grid of bilateral "central" exchange rates with upper and lower intervention points side by side with parities expressed in ECUs that serve as the basis for calculating a divergence indicator. We believed, and still believe, that if the new system was not to duplicate the defects of the previous "snake" timely unilateral action would be required to prevent the divergent currency from moving too far away from its ECU rate unless the existence of fundamental disequilibria indicated the need for a revision of central rates. Given that it is impossible to rule out changes in preferences and shifts in the composition of official reserves towards a few particularly stable European currencies, the failure to lay down guidelines for a common policy towards the main non-Community currencies, in particular the dollar, strongly underlines the need to give special treatment to debts accumulated involuntarily as a result of interventions carried out by surplus countries.

These points, which are of importance for the symmetry and equitable apportionment of the burden of adjustment within the system, have not yet been acknowledged, as the detailed examination of these matters has been postponed until the experience gathered in the first few months of operation of the EMS has been evaluated.

Experience so far would seem to confirm that the bilateral margins for currencies other than the lira are too rigid, as may be deduced not only from the rates of the pound sterling, which is not included in the exchange rate mechanism, but also from the fact that bilateral tensions have frequently developed within the system, in particular between the Danish krone and the Belgian franc before the "ECU alarm" was triggered and later between the deutschemark and the Belgian franc, which had by then crossed the threshold of divergence. In the first planned review of the system unresolved questions of general significance will have to be discussed afresh; these include the question of the optimum combination between bilateral margins and the indicator of divergence.

Strict exchange rate obligations should be counterbalanced by a progressive reciprocal adjustment of economic and monetary policies; otherwise there would be the danger of suffering a further setback with far graver repercussions on the hoped-for development of the Community towards economic and monetary union than the earlier failure of the Werner Plan. Viewed in these terms, it is clear that Italy must make a particularly strong effort to draw closer to the centre of gravity of the Community. Nevertheless, it is unlikely that reciprocal adjustments in exchange rates can be avoided in view of the disparity in the trend of economic and monetary variables in the countries of the Community. For this reason, relatively wide bilateral margins of fluctuation are useful as they allow central rates to be changed without causing interruptions in market quotations that would render the system vulnerable to speculation.

The credit lines that it was decided at Brussels to open in the name of the EMS, totalling ECU 25 billion or about two and a half times the amount previously available, afford considerable room for manoeuvre in support of the exchange rate agreements; their force as a deterrent against possible attacks on the system is strengthened by the increased liquidity of gold reserves. Steps must now be taken, in accordance with the outline sketched at Bremen, to permit the EMCF to become a true European Monetary Fund endowed with autonomous powers to analyze and guide the monetary and exchange rate policies pursued by member countries and, inter alia, to allot a precise and important role to the ECU in order to promote both the financial integration of the Community and the gradual real diversification of dollar reserves on the basis of agreements reached with the International Monetary Fund and the US monetary authorities.

Finally, emphasis should be laid on the need for fundamental revision of the role to be played by the Community budget in a fruitful process of economic and financial integration. The problem of less developed regions probably calls for tools and methods somewhat different from those used hitherto, applied in accordance with guidelines discussed and agreed at the Community level for development policy in the various sectors and areas. As far as the last proposal is concerned, experience with Southern Italy suggests that it would be advisable to treat investment in infrastructure and labour costs separately rather than grant indiscriminate incentives, particularly if this would lead to negative real capital costs.

The importance of simultaneous action along the lines set out above can be ignored only if a narrow view is taken of the EMS and of Europe.

The exchange rate and inflation

Italy's entry into the EMS occurred at a favourable moment from the foreign exchange point of view, thanks mainly to the overall surplus on the balance of payments, which amounted to 7,000 billion lire in 1978 (5,400 billion lire being on current account) and was still substantial in the first few months of this year.

At the end of April 1979 the official reserves amounted to 27,400 billion lire; gold at book value accounted for almost half of this, the remainder consisting chiefly of ECUs and convertible currencies. The reserves were about 14,000 billion lire higher than the total of official foreign liabilities, foreign liabilities of the banking system and those arising from compensatory borrowing, whereas at the end of 1977 these two aggregates had stood at the same level.

The room for manoeuvre that this affords appears to be adequate in relation to the value of imports, which is now approaching 55,000 billion lire for goods alone. It not only serves to finance possible future current account deficits, but also acts, in the same way as the credits supporting the EMS, as a deterrent against speculation, which prefers to attack the currencies of countries with low reserves, as happened in the case of the lira at the beginning of 1976.

It also became possible once again to supplement the reserves by raising medium-term loans. With the emergence of a current account surplus in the last two years, the terms applied to Italian borrowers in international credit markets have gradually moved closer to those offered to prime customers.

The strengthening of Italy's foreign exchange position was matched by the stability of the effective exchange rate of the lira in the first three quarters of 1978 as a result of an appreciation of 5 per cent against the dollar and a depreciation of 3 per cent against the currencies of EEC countries. In the last few months of the year, when the rate for the dollar remained on average the same as in the preceding quarter in spite of wide fluctuations, the lira was allowed to depreciate by 4 per cent against Community currencies in view of the entry into force of the EMS and the consequent reduction in the scope for exchange rate management.

The precautionary nature of this depreciation has been confirmed by the performance of the exchange rate this year. Whereas the lira remained more or less stable up to the commencement date of the EMS, since then it has appreciated on average, so that yesterday it stood almost 2 per cent higher vis-à-vis the EEC currencies and the ECU.

These changes in the effective exchange rate led to a slight improvement in competitiveness in comparison with the preceding year, amounting to 2-3 per cent in terms of export prices and about one percentage point on the basis of unit labour costs. Making due allowance for the margin of error involved in such calculations, it would seem reasonable to state that the depreciation of the lira was broadly in line with cost and price differentials.

Whereas domestic inflation and the rise in labour costs in the private sector continued at rates well above the European average, the favourable development of foreign trade afforded greater scope for seeking a satisfactory compromise between stability and growth. On several occasions we have discussed the question, which has also been raised by eminent scholars, whether it would not have been advisable last year to have used this latitude to reduce the depreciation of the lira or even bring about an appreciation.

The background to the conduct of foreign exchange policy was determined by the emergence during the year of a larger current account surplus than had been expected (mainly as a result of the increase in the volume of exports, which was twice as large as the rise of 5.5 per cent predicted as late as September in the Government's Forecasting and Planning Report), the persistence of inflationary pressures in the productive sector of the economy and in the public sector and, finally, the hesitancy of the recovery in domestic demand.

Although the authorities were aware of the role played by the external value of the lira in shaping domestic price movements, exchange rate policy was directed towards fostering a rise in exports that would attenuate the external constraint, thus creating the requisite conditions for a recovery in investment and a reduction in unemployment. On the other hand, the authorities sought to hold the cost of imported supplies stable in lira terms by allowing the currency to appreciate gradually against the dollar, in which a considerable proportion of our imports are invoiced, while accepting a depreciation vis-à-vis some other currencies, in particular the deutschemark and the yen, whose exchange rates were influenced by the international process of official reserves diversification.

On several occasions we have ourselves stated that appropriate management of the exchange rate is a necessary component of any counter-inflation policy. However, it is also true that this is not sufficient to ensure success and that it has a limited impact when the aim of improving profitability has high priority in company decisions, as is generally the case at the end of a recessionary phase, or when market imperfections, which affect certain imported goods, are such that the cost benefits resulting from revaluation of the currency are not passed on.

Furthermore, over the longer term the inflationary potential inherent in the growth of the public sector deficit as a proportion of gross national product strengthened the belief that the final result of an appreciation of the lira would be not so much a slowdown in the rate of inflation as a weakening of overall demand and a deterioration in the balance of payments. The recovery in output would thus have been checked and at the same time the necessary condition for a steady continuation of the recovery would have been undermined.

During the past decade inflation has been fueled by the interaction of pressures from abroad — the strongest of these being exerted by energy producers — and domestic factors. Among the latter, those connected with unit labour costs and the inefficient allocation of resources implied by the public sector deficit have been analyzed in greater depth.

As a result of the high level of wage indexation, the excess purchasing power that improvements in wage agreements, supply shortages or other factors may generate at any time is first neutralized by the rise in prices between two cost-of-living wage increases and then immediately re-created. Real wages therefore become inelastic, with regard to imported as well as domestic inflation, in a way that no procedure for permanent collective bargaining could probably achieve.

The potential instability to which this gives rise cannot possibly be underestimated if it is recognized that the main disturbances to the economy do not derive from management of the money supply. Indeed, practically full wage indexation smooths out fluctuations in incomes and prices caused by variations in the volume of funds made available to the economy but magnifies the inflationary effects and the detriment to production induced by the increase in companies' costs. Negotiated increases in nominal wages larger than the growth in productivity lead to a rise in real earnings but reduce the advantage to the firm of expanding production and employment, thus laying the basis for further inflationary pressures. As a result of this process, the immediate benefits obtained by individuals and groups become harmful through their secondary effects on the condition of the working class as a whole and on that of the younger generation.

A deterioration in the terms of trade leads to the same result: if the reduction in disposable income that it causes affects primarily companies, the ultimate effect will fall on the variables influenced by the level of self-financing. A decline in economic activity with real wages remaining unchanged can be avoided if firms accept a reduction in profit margins; the limits to this process are reached all the sooner the stronger are the pressures on profitability.

The declining stability of the monetary yardstick, which should form the sound basis for the majority of contracts, distorts economic relationships and, given the disparities in relative strength among economic agents, leads to unpredictable changes in relative prices. The feeling of uncertainty thus increases, businessmen's time horizons grow shorter and the process of capital accumulation, on which depend both the growth in productivity and the creation of jobs, slows down.

Last year the task of stabilization was eased by the relative calm in the world prices of raw materials. The rate of inflation measured in terms of retail prices was five percentage points below the average for 1977, but in the course of the year it did not decline significantly, remaining well into double figures.

An ominous shadow hangs over the future. Announced or threatened increases in petroleum prices of at least 20 per cent on an annual average basis and the tensions prevailing in the markets for some other goods have created an international environment in which inflationary pressures are once again outweighing attempts to achieve real growth and expand employment.

In a situation where inflationary pressures from abroad were strong but where a large current account surplus continued to be accompanied by satisfactory composition and growth of aggregate demand, the increase in the reserves that has been achieved would make it possible to reconsider the objectives pursued and to make greater use of the exchange rate to neutralize imported inflation.

It would be an illusion, however, to think that exchange rate management alone could lead to achievement of the prime objective of eliminating inflation. This aim will tend inevitably to recede into the future unless simultaneous action is taken to combat all the causes of the rise in prices, from the increase in labour costs to inefficiency in industry, the weakening of competition and the public sector deficit.

Capital formation and foreign trade

The increase in real gross domestic product amounted to 2.6 per cent in 1978; growth was satisfactory at the beginning of the year, faltered in the second and third quarters but recovered in the last few months. The stimulus to production sprang from consumption and export demand, particularly the latter, whereas the process of domestic capital formation did not get under way until late in the year.

The increase of 2.9 per cent in private consumption was larger than that recorded in 1977, but as consumption lags behind developments in income the recovery in the autumn was not sufficient to offset the contraction that had occurred in the first quarter of the year as a result of the advance payment of taxes that came into effect at the end of 1977.

Gross investment continued to decline, however. The fall of 3.8 per cent was due principally to a reduction in stock-building, but investment in machinery and vehicles also fell by 1.9 per cent; there was a slight increase in construction.

The proportion of total resources that the Italian economy allocates to capital formation thus again declined, to 16.6 per cent of gross domestic product, continuing the trend that has been observed since 1974, when it had accounted for 20 per cent.

The driving force behind the recent development of the Italian productive sector seems to have been provided by the light consumer goods industry, itself sustained by foreign demand. The entrepreneurial energy generated by the many small and medium-sized firms operating in this sector stimulated the growth of exports and strengthened Italy's foreign position. If the positions won in international markets are to be maintained, it is essential that industrial relations should not jeopardize the return on capital. Above all, however, the expansion of light industry must be sustained by applied research in the field of intermediate goods, where new technologies are incorporated in the products and where investment involves proportionally higher risks and costs.

The sectors producing intermediate goods, on the other hand, are passing through a severe crisis. They face aggressive foreign competition and heavy financial burdens, and are suffering from the effects of the slowness of growth in final demand, which is keeping capacity utilization at a low rate. In these circumstances the more capital-intensive industries are unable to generate sufficient internal funds to fuel the process of capital formation and are limiting investment activity to the replacement of obsolete machinery.

The failure to mobilize the available resources for the conversion and reorganization of industry and the long gestation period of regulations governing the financial reorganization of companies constitute further obstacles to the stabilization of the Italian economy.

In spite of the fact that there was no shortage of funds last year, private firms gave priority to rearranging their balance-sheet liabilities, borrowing only what they required to complete current investment projects; nonetheless, it was due to their activity that capital formation revived towards the end of the year.

Once again, the delay that preceded this revival was not offset by a flow of discretionary investment designed to make good the serious deficiencies that still exist in Italy's infrastructure. The further slight decline in the public utilities sector demonstrates the continuing difficulty of manipulating such investment in a countercyclical manner. In addition, the electricity generating sector was unable to bring forward its planned investment, in spite of the prospect of supply shortages. Finally, in the state company sector the chronic problem of overcapacity and the related losses in basic industries prevented the sector from giving any stimulus to the capital goods industry.

The exceptional growth in exports, which came to 10.8 per cent in volume terms or twice the rate of increase in world trade, led to a sizeable expansion in Italy's share of world markets and made a decisive contribution towards the development of a current account surplus. However, it would be dangerous to let oneself be lulled by this achievement, which reflects the working of temporary factors rather than structural changes in our relations with the rest of the world.

Exports were boosted last year by the resumption of growth in the economies that are the main markets for Italian goods; domestic demand in Italy grew by barely 1.7 per cent, as against 4.3 per cent in the other six main industrial countries belonging to the OECD. The terms of trade moved in our favour and the competitiveness of Italian products improved as a result of the diversified exchange rate policy; the dollar prices of manufactured goods on world markets rose by 14 per cent, compared with 11 per cent for Italian manufactures. The increase in Italy's market share was also encouraged by the financial support provided for exports of capital goods, which has been stepped up in recent years. Finally, for a large part of the year the slowness of growth in domestic demand continued to have the short-term effect of curbing imports, which was the basis of the policy begun at the end of 1976 to restore external equilibrium.

During 1979 the favourable movement in some factors may be reversed; this is already happening in the case of the world market prices of raw materials. On the other hand, the ratio of imports to national income shows no evidence of a reduction in the propensity to import. The income elasticity of merchandise imports worked out at 2.9 on average in 1978, a figure in excess of the long-term value. The increase in the ratio of imports to national income was admittedly due in part to the exceptional growth in exports, which have a high import content, but the hoped-for increase in the proportion of national income allocated to investment would have had a similar effect.

The composition of Italy's foreign trade in manufactured goods showed a continuation of the trend apparent since 1973-74 towards increased specialization in traditional products with a comparatively low technological content; at the same time, the deficit on chemicals reached 1,200 billion lire. As a consequence, Italy's trade is even more sensitive to the relationship between the prices of manufactured goods at home and those in international markets and is increasingly exposed to competition from developing countries.

There is therefore no lack of contradictions in the picture we have painted. The fact that the results achieved in world markets in the last two years have been better than expected is not due solely to a combination of favourable circumstances; the Italian economy has also displayed an underlying vitality, without which any progress would be impossible, now or in the future. The resources that have been created must be used to proceed towards greater stability and balance, not to give the illusion that the external constraint has been broken and that the aims of an advanced industrial society are now easily attainable. Forms of unregulated or abusive employment, which account for an appreciable proportion of the reduction in costs achieved by Italian industry in the last few years, cannot constitute the basis for a permanent strengthening of the productive sector; as a remedy it is not only socially undesirable but also economically unrepeatable. The backwardness of Southern Italy, the lack of public services, the damage to the natural environment and imbalance among sectors are problems that will not be resolved in future solely by the momentum generated by economic vitality and individual motivation, as indeed they have not been in the past. This energy should instead be directed partly towards providing social investment and creating social harmony without, however, being dissipated in a system of industrial relations that is too rigid and ill-suited to the profound changes that are necessary if the Italian economy is to follow a development path characterized by full employment of the factors of production and consistent with the external constraints.

The systematic outline of a policy designed actively to promote the necessary structural adjustments was laid down in the three-year Plan presented by the Government in January. Apart from demand management, it proposes that an extensive redistribution of resources be carried out in order to eliminate waste and favour investment in the productive sector and in public services. In order to achieve these objectives it is not sufficient to free the necessary resources for investment by holding down the public sector deficit and unit labour costs; it is also necessary to attend to the efficient use of the human capital represented by the accumulated technical and organizational knowledge at our disposal.

Monetary developments and the national debt

Turning to monetary developments, we note that last year the central bank's activities on domestic markets were carried out against a background of strong expansionary stimulus created by budgetary policy and, to a lesser extent, by management of the exchange rate.

The Treasury borrowing requirement of 34,000 billion lire and the balance-of-payments surplus of 7,000 billion lire, which together indicate the magnitude of potential monetary growth, came to the equivalent of 19 per cent of gross domestic product in 1978. Since the crisis of 1963 this ratio has averaged about 7 per cent and in no year has it reached last year's level, the previous peak being 13 per cent recorded in 1977.

The stimulus to the creation of money imparted by Treasury expenditure is irregular, more so even than that produced by foreign trade, and it percolates slowly through the economy; before this process is complete the central bank sometimes has to meet the economy's liquidity requirements, at least in part. For example, the substantial Treasury disbursements made in the last few days of 1978 helped to inflate the recorded money supply, partly because the economy had already obtained funds through other channels which did not flow back to the central bank until after the turn of the year.

In these circumstances the monetary authorities proposed to check the creation of liquidity while at the same time coaxing holders of government securities towards longer maturities, two objectives that are not always easy to reconcile, for while the offer of adequate yields on Treasury bills is the immediate means of absorbing liquidity and thus achieving the first aim, pursuit of the second requires the yield on long-term securities to be significantly higher than that on shorter-term paper. To create this differential by increasing the rate of interest on long-term securities would have made fund-raising by the special credit institutions and the financing of investment too costly; greatly reducing the yield on Treasury bills, on the other hand, would have weakened the incentive for savers to place funds in financial assets other than bank deposits and would more quickly have wiped out the yield advantage over assets denominated in dollars. The Treasury bill rate was thus at the centre of partly conflicting requirements, none of which it was felt should be given systematic priority over the others.

In the light of these considerations, which were the subject of a constructive dialogue with the Treasury throughout 1978, it was decided to allow the interest rate on shorter-term paper to fall slightly and to increase the proportion of government issues with longer maturities. The expansion of the monetary base, which appears to be very high when viewed in terms of the end-year figures, was slightly less than one third of the potential mentioned above; in the recent past there has been no other instance of liquidity absorption on such a large scale.

Although the sterilization of monetary base reached considerable proportions, it did not prevent the economy from being amply provided with liquidity, partly because the additional funds are only gradually transformed into other financial assets; hence the money supply rose by 23 per cent during the year and its ratio to gross domestic product further increased. At the beginning of 1979 monetary growth declined, the increase in bank deposits in the twelve months ending in March coming down to 20 per cent.

The reduction in the flow of funds brought about by the ceiling on short-term bank lending had only a partial effect on firms owing to the operation of other factors that generate liquidity, such as higher Treasury transfers and increased self-financing.

The impact of monetary policy on the economy depends not only on the objectives pursued but also on the instruments employed. The same macroeconomic variables — prices, money, national income — are affected by the choice of the method of intervention in ways that may not be immediately apparent but are nevertheless lasting and profound. In the last few years we have therefore endeavoured, even in times of very adverse conditions, to create a set of instruments that would leave the markets the greatest possible operating freedom and ensure the efficiency of interventions.

In the capital market an important step in this direction was taken last June, when the security investment requirement was reduced from 30 to 6.5 per cent of the increase in deposits. The incidence of compulsory investments in securities on the flow of deposits is now lower than at any time since 1973. Nevertheless, the market for fixed-interest securities is still far from free. The banks are still required not only to fulfil their investment obligations, albeit at the lower rate, but also to reinvest the proceeds from securities that have matured or been sold; in 1978 such renewals came to about 3,500 billion lire. In the last two months the new regulations have directed purchases for replenishment of the compulsory portfolio towards issues which no longer have to be bought under the investment requirement. For the immediate future it is to be hoped that the increasing inflationary pressures will not make it necessary to retrace the steps taken in the past year.

In the money market the measures taken by the Treasury with regard to new issues and by the Banca d'Italia with regard to secondary trading were coordinated so as to steer investors towards longer maturities. The monthly offering of three-month Treasury bills, which had amounted to 1,000 billion lire in January 1978, was gradually reduced and eventually discontinued in February of this year. Whereas the Treasury borrowing requirement totalled 34,000 billion lire last year, the value of Treasury bills outstanding rose by only 5,700 billion lire. The Bank's portfolio of bills, which had stood at 7,590 billion lire at the beginning of 1978, amounted to 694 billion lire yesterday. Insofar as it has lain within our power, we have sought to achieve these results by refining the techniques of market intervention, encouraging the market to set its own rates, spreading sales over a wider range of securities, intervening as buyers as well as sellers and establishing links with the main market operators via terminals. Within the next twelve months we aim to set up a pilot system for the transfer of Treasury bills by means of book entries and to introduce methods of purchase that will also enable non-banks to take a position in Treasury bills, thereby permitting them to reduce the risk of illiquidity while still running the risk of losses.

Still with regard to the money market, the reduction in stamp duty on bankers' acceptances and the introduction of new supervisory regulations have largely eliminated the disparity in the terms of issue between the Treasury and other issuers. However, the organization of professional skills and resources that constitutes a market does not develop within the space of a few months. Bankers' acceptances to the value of a few hundred billion lire have been placed so far; these instruments are meeting with encouraging success, partly because they introduce a degree of flexibility to a system that continues to be constrained by the ceiling on bank lending.

In the foreign exchange markets the requirement to finance export credits in foreign currency has been abolished and the ceiling on forward operations against lire has been raised; in addition, the period for the advance payment of imports has been doubled and the length of time that foreign currency and suspense accounts may be held has been extended. Italian businesses are thus once again able to enjoy facilities normally available in other countries and provided in Italy on previous occasions when the foreign exchange situation has allowed. In the present circumstances many restrictions could be further eased, especially those on the period for the payment of imports and exports, the permitted duration of foreign exchange accounts, foreign currency travel allowances and commercial transactions that do not involve foreign exchange formalities. We recently submitted proposals to this effect to the authorities responsible, in accordance with the need to adapt foreign exchange controls swiftly and appropriately to the underlying and cyclical balance-of-payments situation.

Compared with other nations the Italian people is at a double disadvantage in the exercise of economic freedom in that its savings must be invested within the country and in a currency that is being rapidly eroded by inflation; expanding the freedom to carry out and settle current transactions to the full extent permitted by the country's external position is also a way of reducing the area in which the law is not fully respected as it does not meet society's true needs.

The growing requirement for efficient markets also reflects a development that has begun in Italy and has been observed in other countries, namely the transition from a financial system orientated towards the institutions to one orientated towards the markets. As far as monetary policy is concerned, this development is apparent in the switch from refinancing the banks to effecting mainly purchases and sales of government securities.

Over the years the growth in the public sector borrowing requirement has been accompanied by that in the national debt. The two phenomena have not been exactly parallel, as inflation causes the former to increase more than the latter: as nominal interest rates adjust to the higher rate of inflation and old securities mature, expenditure and the current deficit increase by an amount that from an economic point of view simply represents a restoration of the real value of existing debt. The proportion of private savings taken up by the public sector has grown dramatically — outstanding government debt amounted to the equivalent of 70 per cent of gross domestic product at the end of 1978, compared with about 45 per cent in the three years from 1968 to 1970.

When inflation was more acute, the Treasury covered its financing requirement exclusively by issuing very short-term securities; later it reverted to offering longer maturities — twelve months in November 1976, two years in June 1977 and five years in October 1978.

The steps taken in the last three years have merely slowed down the decline in the average residual term to maturity of government securities; at the end of 1978 that of the portion held by the market was three years and five months, well under half that recorded ten years earlier.

It is true that if yields are adequate, savers are not induced to increase their expenditure by the fact that their financial assets are invested in short-term securities; it is also true that the use of such securities makes it possible to adjust nominal yields to variations in the rate of inflation without needing to introduce indexation mechanisms. These considerations notwithstanding, the gradual return to a national debt structure in which long-term paper has its place and, more generally, the definition of a national debt policy are among the more demanding problems facing the development of the financial markets in the next few years. If these problems are to be properly solved, public authorities must improve and develop their knowledge and experience of market techniques as their operations expand. It may also be necessary to review the institutional arrangements which enable the Treasury to use the central bank as a channel for placing issues with savers while at the same time obtaining central bank credit at a rate that bears no relation to those prevailing in the market.

However, it will not be new management techniques — which might be required or even justified by Community harmonization — that will bring the rapid growth in the national debt under control; this will be achieved only by neutralizing certain mechanisms for indexing disbursements, restructuring expenditure so that it contributes towards capital formation, developing a policy for utility charges and public sector prices which ensures that, taking inflation into account, goods and services are not offered at less than cost or at least not at prices that conflict with the objective of reducing certain types of consumption and, finally, implementing a tax policy aimed more at widening the tax base than increasing the tax burden of those who are already taxed both by the revenue authorities and by inflation.

In recent years the first steps have been taken towards modernizing fiscal policy instruments, ranging from reform of the system of taxation to that of the procedures for drawing up the Budget. The essential requirements in terms of knowledge and legislation have thus been met not only for the reorganization of public finance but also for a reduction in the burden placed on monetary policy.

Banking intermediation and monetary objectives

The care taken to ensure continuity in the practical and theoretical approaches adopted does not eliminate the need to analyze and review the forms that monetary policy takes, ranging from the more technical choice of the instruments to be used to the definition of intermediate and final objectives — indeed, it strengthens it.

Hence, when a monetary situation developed in which credit control was less essential but there was a greater need to reduce the monetary element in total financial assets, the question again arose whether action should be taken to reduce intermediation through the banks. We examined the experience of the United Kingdom, where a progressive reserve requirement on deposits keeps fund-raising by the banks within the growth range set by the central bank.

It is true that the change-over from the ceiling on lending to more strict control of deposits by penalizing them progressively would restore the autonomy and responsibility of bankers and that such a method would reduce the share of deposits in total financial assets much more effectively than is sometimes possible with a classic proportional reserve requirement. In the United Kingdom, however, this requirement is practically redundant as compulsory reserves can also take the form of Treasury bills and interbank deposits, both of which are in abundant supply at market rates. By the same token, in Italy a progressive requirement using bonds as the reserve instrument would be effective only at very high marginal rates and on securities issued at interest rates far removed from those of the market.

In more general terms, the factors determining the economy's demand for money cannot be ignored when evaluating possible innovations in this field. The rate of growth of deposits held by the various economic groups of which a country is composed displays regional disparities, reflecting in particular differences in the growth of income and in financial market imperfections. Where the banking system consists of a few very large banks with branches throughout the country and a great many other credit institutions operating mainly in the capital, as in France and the United Kingdom, these disparities can be disregarded to some extent. However, where regional banks are widespread, as in Italy and the Federal Republic of Germany, there is a high risk of penalizing genuine and spontaneous movements along with reprehensible practices designed to corner the available deposits.

In Italy the growth of individual credit institutions reflects that of the areas in which most of their business is conducted rather than the management or interest rate policies they pursue. The fastest expanding banks are not necessarily those that offer their clients the highest rates.

These considerations illustrate the difficulties we see in applying the British method to Italy but do not invalidate the importance of attracting the public towards non-monetary investments and even calling on the banks to play a greater part in this respect. However, the national debt policy pursued by the Treasury in the year that closes today, the bold course followed by a few banks and the action taken by the Banca d'Italia both on the secondary market and in easing a number of constraints have already made it possible to take a few steps in the desired direction without causing sudden changes in the existing arrangements. Further progress could be encouraged by introducing new regulations.

For example, it has been proposed that the action taken in recent years to strengthen the capital base of the credit institutions should be linked with the measures aimed at discouraging banks from raising more funds than they can profitably employ. The observance of minimum ratios between own funds and deposits would be consistent with the careful attention that the managers of credit institutions are required to pay to balance-sheet equilibrium and profitability; this is illustrated by the experience of other countries, such as the Federal Republic of Germany and Switzerland. Such a system could be applied in Italy after the procedures for increasing the capital base of the banks under public ownership have been revised, as recent experience in France has demonstrated.

Consideration has also been given to linking the yield on compulsory reserves to that on the deposits accepted. For instance, no interest might be paid on the portion of the reserves set aside in respect of deposits which the credit institutions had declared bore interest above a given rate. This would resemble the British scheme insofar as it would provide for incentives rather than prohibitions; it would differ from it in that it would not discourage growth as such but only that achieved by offering deposit terms that would make it difficult to earn a profit on the funds. Furthermore, it would not raise problems with regard to the definition or supply of reserve instruments.

At the end of 1978 the monetary and credit aggregates ceased to be the subject of undertakings to international organizations for the first time since 1974. However, new obligations of a different nature and origin came into operation in the first quarter of 1979, namely the exchange rate commitment arising from the European Monetary System and the requirement to present complete estimates of financial flows and total domestic credit expansion to Parliament in accordance with the law reforming government accounting procedures.

Italy's participation in the EMS implies an undertaking to achieve in a short space of time a degree of monetary stability comparable to the average of the Community to which we belong. This extends far beyond the exchange rate variable to involve public finance, productivity, wages and prices.

After the presentation of the three-year Plan, which charted a course for Italy's rehabilitation within the European Community, the threat of a revival in inflation caused mainly by external factors grew more acute. The monetary authorities considered it advisable not to make a corresponding correction in the target for growth of the money stock but to keep it at the rate previously announced.

The monetary policies of the seventies appear to be influenced both by greater awareness of the limits of monetary action in the short run and by the practice of announcing annual targets. The two phenomena are interrelated, because the announcement of targets is only meaningful when it is firmly believed that sharp course corrections will not have to be made at every turn, and both derive from the view that the monetary aggregates should be regulated only to the extent necessary to provide a frame of reference that is stable in quantitative terms and does not vary with changing circumstances. It is perhaps already possible to distinguish the aspects of this view that are most likely to endure from those that appear to be short-lived.

In a society in which scrutiny of the actions of the executive by the institutions and by public opinion has become more stringent and better informed, the openness inherent in the announcement of monetary targets will remain a permanent feature. In the macroeconomic field the actions of central banks are no longer cloaked in silence, and perhaps never will be again. Whereas in the past silence was seen as a guarantee of independence, today this is achieved by giving explicit account of one's action in a way and at a time that do not undermine its effectiveness.

On the other hand, it is now taken for granted that economic actions and reactions develop over time and that an economic policy is effective if it does not create too wide and lasting a discrepancy between the behaviour imposed on economic agents and that towards which they are impelled by the combined force of the prices, propensities and opportunities present in society. The illusion that administrative controls offer a short cut has all but disappeared. The time lags that occur before the effects of economic policy are felt are recognized as the healthy, rather than aberrant, manifestation of a system which assigns the market a role, albeit not an exclusive one. These beliefs can also be considered as firmly established.

One aspect of the announcement of monetary targets which in our view is less valid and sound is their rigidity. Events in 1978 led Switzerland to abandon its monetary target and to set an exchange rate objective; the Federal Republic of Germany accepted an increase in the money supply of 11.5 per cent after announcing a target of 8 per cent, and for 1979 it has set a growth range with an upper limit one and a half times the lower figure. However it is measured, the divergence from the targets recorded in Italy in 1978 appears in this light to be one of the smallest.

Monetary targets have come to be set in increasingly flexible ways, by indicating a desired range rather than a precise value or by periodically revising the annual objectives. This is the orientation adopted by the IMF in its new regulations regarding the conditionality of loans to member countries.

The shift towards greater flexibility brings us back to the ultimate problem of central banking, that of monetary management and inflation. We realize today that the inflation of the last few years is a different phenomenon from the violent explosions and slow rises in prices that occurred in the past because of its high rate, its persistence, its universality and the fact that it is deeply rooted in expectations; we also realize that it cannot be fully explained by a sudden, widespread and persistent weakness on the part of central banks or by the profligacy of governments and that it is perhaps related to a more profound change in social relationships, through which the mechanisms that determine prices — and hence that universal price, the value of money — have themselves been transformed.

Today, as in the past, the creation of money, and hence the fixing of its price, is in the hands of a monopoly. However, to a much greater extent than in the past the prices of other items such as labour, raw materials and manufactured goods are fixed in conditions of near-monopoly by forces mobilized to protect sectoral interests, and the variations in these prices, which ultimately determine that of money, are often rigidly interconnected.

Management of the money stock aimed exclusively at stabilizing its value used to set off a process of adjustment that would last a known time and spread throughout the economy as a vast number of individual adjustments were made; in this process the temporary costs of stabilization were economically, socially and politically acceptable because they were very widely distributed. Today they would be concentrated in those parts of the economy whose resistance had finally been overcome, perhaps for ever, bringing unemployment to vast areas and broad sections of society and causing the disruption of whole industries, including banking; the economic inequalities would become intolerable. Opposing more concentrated and inflexible processes of price determination by applying the monetary monopoly more rigorously without the assent and confidence of those who operate in the economy would mean pursuing monetary stability by compulsion, as has been the case in some countries; this would lead to a diversion and waste of resources not unlike that which accompanies a price freeze.

The experiences of different countries suggest that every modern economy is both too dependent on events abroad and too exposed to autonomous, albeit interrelated, domestic stimuli for the central bank to be able to pursue monetary stability without counting the cost unless the difficult battle of persuasion has been won throughout society. In the conditions prevailing today, monetary policy cannot replace the exercise of discipline in the decisions and behaviour of the whole of society; when it has been successful, it has guided and confirmed decisions that have been reached on the basis of reason and experience.

Within this narrow domain the attempt to reconcile the operational requirements of the markets with the need to regulate them will continue to require the availability of discretionary powers, the proper use of which must continue to be guaranteed by the competence, prestige and independence of the institution that exercises them. This function, which modern constitutions confer on the executive, cannot be regulated by either bureaucratic rules or legislation. Both must be seen as the means of creating and protecting the scope for discretionary choices, rather than for suppressing it.

Subsidized credit and its effect on the financial system

The difficulties facing a part of the financial system are the mirror image of the crisis in important sectors of the economy brought about by international and domestic factors, not the least of which is the subsidized credit mechanism designed to promote development and regional balance within Italy.

Efforts to direct the course of the economy were intensified in the 1960s in response to the adverse effects that uneven growth had on employment, especially in the areas in which the establishment of industry was most difficult and the natural increase in the population greatest.

These were the years in which planning was explicitly centred on industrialization and in which new bodies and procedures were set up, including consultation between firms and government departments (so-called "planned negotiation"), compulsory advance notification of all intended investment of any importance and the introduction of "declarations of eligibility" for subsidies.

The creation of large industrial complexes, which would then attract smaller firms, was judged to be the most suitable means of setting in motion a self-sustaining process of development in Southern Italy.

Two contrasting trends began to emerge in the activity of the financial intermediaries — on the one hand, increasing risk as investment was stepped up and concentrated in areas with little or no industrial tradition and, on the other, declining autonomy in decision-making as the range of projects judged to be consistent with the country's development aims was widened. Moreover, in several instances the agencies providing finance had a special legal status, so that their governing bodies were direct or indirect appendages of the very government departments responsible for granting credit concessions.

The Banca d'Italia did not fail to draw attention to the hidden dangers that threatened the credit institutions as priority came gradually to be given to social and political considerations in the assessment and location of investment projects. It would take too long to quote here all the passages in past Annual Reports that summarize the Bank's position.

A system based on an appropriate distribution of responsibilities requires that financial intermediaries, which undertake to pay interest on funds accepted from savers and to repay them, should be entitled to examine the projects submitted to them, and therefore to evaluate the risks they are accepting, before any pronouncement is made by the authorities regarding eligibility for subsidy.

In some cases authorization by the bank supervisory authorities is required; this is granted only after the credit institution has decided to provide finance and does not, in any case, imply an assessment of the merits of the project. The regulations state that supervision of the industrial credit institutions shall be confined to those established in recent years and shall be limited to loans involving borrowers whose indebtedness is large in relation to the capital and reserves of the lending institution. In the case of the three institutions providing medium-term credit to Southern Italy, this power has been delegated to the Bank by the Interministerial Committee for Credit and Saving and has therefore been exercised in accordance with the criteria for promoting and supporting industrialization in Southern Italy laid down by the law under which the Committee was entrusted with this task. With the constant approval of the Committee, the Bank has therefore authorized these institutions to exceed their lending limits whenever they have requested permission to do so.

The economic assessment of projects is based on long-term forecasts and hence "even when it is made with the greatest caution cannot be, nor must be presumed to be, infallible" (Annual Report for 1966). Furthermore, when investment on the scale required to implement a strategy of industrial development in depressed areas is involved, it is unthinkable to demand that the entrepreneur provide guarantees which, from an economic point of view, will give the lending institution greater protection than that afforded by the mortgage on the plant.

The action described above and the strategic role assigned to the steel and chemical industries are confirmed by analysis of the declarations of eligibility regarding investment in Southern Italy. During the four years from 1967 to 1970 a total of 3,376 declarations were issued in connection with fixed investment amounting to 4,900 billion lire at current prices. More than 2,800 billion lire of this sum related to investment in the steel and chemical sectors. In 1971 another 890 declarations were issued for investment totalling 3,480 billion lire, nearly four fifths of it in the area and sectors in question.

The concentration of investment in branches of industry that are notable for the large size of plant required and the small number of companies involved was consistent with the aim of reaching the threshold of viability by means of economies of scale and integrated production processes and bringing Italy's production capacity up to the level achieved in the leading industrial countries. In the case of chemicals such a course of action was also determined by the worsening of the chemical trade balance, which moved into deficit in 1967 and thenceforth recorded increasing shortfalls, whereas in the other industrialized countries it is one of the largest surplus items. Hence in 1971 the Interministerial Committee for Economic Planning (CIPE) approved a separate plan for the development of the sector; from then onwards groups of experts and special committees assessed the chemical companies' investment programmes with reference to the planning framework that had been drawn up.

After 1973 the inflationary pressures of foreign and domestic origin increased the cost of implementing the programmes that had been started. Consequently, at a time of further deterioration in the chemical trade balance owing partly to supply shortages, the authorities were faced with the dramatic choice between abandoning the projects, at a heavy cost in terms of lost employment and wasted resources, or completing the work that had already been approved, which would entail an enormous increase in the amount of credit needed and a worsening of the financial burden, mainly as a result of the rise in the cost of prefinancing.

In 1974 the CIPE passed a special resolution requiring the declarations of eligibility that had already been issued to be revised on the basis of the changed monetary yardstick and the new technological needs. For investment solely in the chemical industry in Southern Italy, declarations regarding investment totalling nearly 2,000 billion lire were amended in the two years 1974 and 1975, and certificates for further investment worth 3,000 billion lire were issued. This decision was influenced by the view, which was widely held both in Italy and abroad, that the duration and severity of the crisis would not be such as to justify substantial changes in the programmes of sectors in which investment is necessarily of a long-term nature.

The subsequent development of prices and national income in Italy and the rest of the world did not correspond to the forecasts which had been made both here and at the international level. Only part of the substantial increase in the cost of factors of production and, in particular, of raw materials used by the chemical industry could be passed on to output prices. Between 1972 and 1978 the index of the wholesale prices of chemical products rose one and a half times, whereas plant construction costs nearly doubled and the price of oil increased by a factor of about six. On the other hand, although the increase in the prices of chemical products was insufficient to preserve the equilibrium of companies' profit and loss accounts, it was large enough to cause a reduction in consumption and a strong shift towards the use of substitutes. The Italian chemical industry was left with a declining share of a market that was expanding more slowly than expected owing to the fall in the rate of economic growth. The two parameters upon which the plans for expansion had been based, namely the growth of national income and the high income elasticity of demand for chemical products, thus failed to provide the necessary momentum.

The annual average rate of growth in chemical production in the OECD countries was 2.6 per cent in the period from 1974 to 1977, as against 9.2 per cent between 1969 and 1973 and forecasts prepared by international organizations indicating that it would slow down slightly from the rate recorded in the previous decade but remain high throughout the seventies. In the case of Italy, the 1971 chemical plan forecast an average annual expansion of between 10 and 11 per cent during this period. The rate actually achieved for primary production over the three years from 1970 to 1973 was still above 8 per cent, but in the period from 1974 to 1978 it fell to below 1 per cent.

The world crisis in the steel and chemical industries is more serious for the latter in Italy, owing to its lower degree of specialization in refined products, the large number of plant yet to come into operation and the complete lack of action by the Community with regard to the intense competition within the EEC. Since the plant nearing completion are all located in depressed areas, the crisis in basic industry, and especially that in the chemical sector, represents a serious problem for the development of Southern Italy.

The industrial and financial reorganization of these and other sectors in difficulty has become a matter of urgency, especially if the crisis is to be prevented from spreading to the credit intermediaries.

The bad debts and arrears in instalment payments owed to the special credit institutions rose from 650 billion lire at the end of 1974 to 2,500 billion lire at the end of 1978, or from 2.1 to 4.6 per cent of their total domestic lending; as a proportion of their net assets, they rose from 30 to 58 per cent. The position of a number of industrial credit institutions is especially serious because their defaulted loans are concentrated in a small number of industrial companies, some of which still have investment projects under way.

The action required to re-establish orderly and profitable growth in production involves three areas — companies, financial intermediaries and legislation in the strict sense of the word. The result will depend on the consistency and timeliness with which measures along the lines indicated are combined.

The solution of companies' economic problems is a prerequisite for concrete aid from the credit institutions, as provided for in the recent law on financial reorganization. We reaffirm the principle that the injection of equity capital by credit institutions must not exceed their uncommitted net assets and must be confined to companies with sound prospects of returning to economic and financial equilibrium, just as we believe it essential that the financing of industrial companies should be kept separate from the function of management by the establishment of consortia.

In view of the seriousness and social repercussions of the condition of some firms, solutions have been sought that would provide an alternative to bankruptcy proceedings. If the banks consider that the consortium approach offers some prospect of success in these cases, in which the industrial risk is more difficult to assess, the Interministerial Committee for Credit and Saving will acknowledge the common interest in maintaining employment and production by granting authorization to set up the consortium, a power with which it has been appropriately entrusted under a recent government decree that has to be converted into law. On the other hand, for those cases in which the consortium approach is judged unsuitable or proves to be unfeasible, the recently introduced procedure for special administration provides an instrument which will, as far as possible, avoid causing disruption of the economy.

Even when action to restore the health of companies includes the immediate injection of funds, the return to profitability requires a fairly long period of time, during which the special credit institutions may encounter liquidity problems, since on the one hand they are the creditors of companies which are unable to service their debts regularly and, on the other, they are nonetheless obliged to honour their commitments towards the holders of coupons and bonds due for redemption.

The provision of fresh capital, which a number of financial intermediaries have in fact undertaken and which has been facilitated by the recently approved public injection of funds, may be insufficient when the total of instalments in arrears and those to be rescheduled is too large. Moreover, since the renegotiation of loans concerns the rate of interest as well as the maturity, it may prove impossible to raise the funds on the capital market. On the other hand, the tax concessions granted under the law for restoring companies to financial health, which only apply to the extent that there are taxable earnings, can reduce but not eliminate the impact of a liquidity crisis on the stability of the credit institutions.

The government guarantee that was recently introduced for specific series of bonds issued within certain limits by industrial credit institutions makes it easier to place securities with the public and, if necessary, enables them to be purchased by the Banca d'Italia. At all events it should be pointed out immediately that the strength of the credit institutions can be preserved provided that the cost of rescheduling the loans of ailing companies does not jeopardize their economic equilibrium and, in general terms, that the companies in question are themselves restored to health. Should this not happen, it may be necessary to set up preferential financing mechanisms for the credit institutions themselves.

The problems and risks arising from the process of resource allocation explain the difficulties that have been encountered, in particular, by those financial intermediaries that have been prevented from diversifying the sectoral composition of their lending by the geographical limits to their activity. The transition since the war from an essentially monopolistic structure of industrial credit to a system based on an extensive network of institutions is at the root of the problem. In order to overcome this difficulty, it may be advisable to merge institutions with narrow operating bases. The requirements of companies, wherever they may be located, might be better served by widening the geographic scope of the intermediaries than by increasing their number.

In any case, the efficient allocation of resources depends on the separation of responsibility. In order to achieve this, the institutions appointed to select projects for financing must once again be given considerable freedom of choice. It is in this sense that the provision of Law No. 183 of 1976 regarding the priority to be given to the technical and financial analysis over the assessment of eligibility for subsidy should be viewed. As we said in the Annual Report for 1971, "The system will be viable if it can be prevented from degenerating into a condition in which responsibilities become blurred and attempts are made to determine where they lie by means of administrative and judicial investigations".

The task of banking supervision and its safeguards

The origins of the more incisive approach to banking supervision adopted in Italy and abroad are to be found in the difficulties encountered by industrialized countries in recent years. Inflationary pressures, the fitfulness of production, the decline in the rate of economic growth, the variability of relative prices and exchange rate fluctuations have all contributed to making financial systems more vulnerable to the dangers of insolvency; the stability of the credit intermediaries has been undermined not only by the strains deriving from the high level of indebtedness and the reduced cash flows of firms, but also in certain cases by speculative operations, primarily on the foreign exchange markets.

In 1974-75 this instability entered its most serious phase, not only in Italy but also in the United Kingdom with the financial crisis among the fringe banks, in the Federal Republic of Germany with the Herstatt affair and in the United States with the increase in the number of bank failures. Subsequently, even neighbouring Switzerland was affected by events concerning a major bank.

Increasing financial integration, due to the dense network of foreign branches and subsidiaries maintained by the major international banks, and the development of international markets trading in euro-currencies have increased the likelihood that difficulties experienced by one or several credit intermediaries in one country will also have serious repercussions on banking systems elsewhere. For this reason the supervisory authorities have also been active in the area of international cooperation; it is hoped that through the exchange of information it will be possible to detect potentially dangerous situations at an early stage and to standardize the methods and criteria for supervision. In several countries the legislature has shown its concern for the protection of savings by introducing deposit insurance schemes or improving existing arrangements.

In Italy the task of the supervisory authorities has been rendered more exacting by specific factors arising from the considerable growth in financial intermediation, the desire to improve the operational and allocative efficiency of the credit intermediaries and the closer interdependence between banks and special credit institutions, partly for reasons of economic policy. Moreover, it has become necessary to verify not only that the controls recently imposed on the composition of bank assets are being observed but also that the banks are able to bear the cost involved.

The activity of the supervisory authorities is described at length this year in a special chapter of the Report. In giving an account of the areas to which supervision applies and the forms it has taken, one of our concerns has been to point out that in recent years inspections have on the whole been evenly distributed among the banks and throughout the country.

When judging the behaviour of banks, the authorities have constantly been concerned to capture the true intention of the provisions, some of which date back extremely far. Furthermore, in examining the forms in which credit is granted by private and public financial intermediaries, the Bank duly interprets the regulations on the basis of case law and legal opinion in a manner consistent with the need to distinguish between types of finance that conflict with the interests and statutory aims of the institutions and those that deviate only formally from normal practice or from the institutions' internal regulations. In so doing, the Bank follows the principle that the same discipline should apply to the directors of all credit institutions and banks, whether public or private.

It would not, in fact, make economic sense if the consequences drawn from essentially identical actions were to vary according to the legal status of the credit institutions concerned. Those public credit institutions which are most deeply involved in providing financial support for the development of less prosperous areas would be placed at a disadvantage, their directors would become reluctant to take responsibility for management decisions and the tendency for credit-granting to degenerate into a bureaucratic procedure would be intensified. In order to counteract these tendencies, the Banca d'Italia is careful to ensure that the technical *ex post* assessment of loan operations does not influence the legal judgement of responsibilities.

In connection with an inquiry conducted into one of the special credit institutions, the Governor of the Banca d'Italia has been accused of not having been objective in his decision not to transmit to the judicial authorities, on his own initiative, the information and data contained in the inspectorate's report.

The subsequent proceedings have initiated a debate on the supervisory authorities' powers in their relations with the judicial authorities which will make it possible to clarify the position of the Banca d'Italia. Both the judiciary and legal opinion have made valuable contributions to this debate and will continue to do so.

Article 10 of the Banking Law directly concerns the relations between credit authorities and judicial authorities. In interpreting and applying this provision the supervisory body has always sought to maintain continuity in its actions and those of the credit intermediaries and, at the same time, to ensure that they meet the changing economic and social requirements in Italy and elsewhere. This is a tradition that each Governor hands on to his successor in order to preserve the unity and credibility of the credit system and its ability to fulfil its commitments towards the community.

The importance of Article 10 of the Banking Law lies not only in the well-known clause requiring officials of the supervisory agency to report any facts and irregularities they ascertain to the Governor alone, even when these represent a violation of the law, but also in the clause stating that information and data concerning the credit institutions shall be subject to official secrecy.

This article constituted recognition of the banking system as a group of firms subject to supervision in order to assess their solvency and liquidity, an exercise that also involves determining whether they are correctly managed. Such supervision is one of the elements on which depositors' confidence in the banking system reposes; another is the confidentiality of relations between the credit institutions and their customers, which is guaranteed on the one hand by the banks, through the observance of banking secrecy, and on the other by the supervisory authorities, through the application of official secrecy and the requirement to report only to the Governor.

The banking legislation, which was enacted later than the penal code, entrusts a high authority of the financial system with the task and responsibility of reconciling the requirement for confidentiality in banking operations, in order to ensure the confidence of depositors, with the need to maintain the efficacy of the general body of law by punishing violations.

Article 10 of the Banking Law is designed to give the Governor the power to defer the submission of a report to the judicial authorities should this be considered advisable in view of the harmful effect that the ill-timed institution of criminal proceedings might have on the credit institutions and on the action that the Governor himself can take to ensure their survival and, at all events, to protect the interests of depositors.

The law intended that the Governor should be able to assess facts discovered in the course of supervision and to weigh the requirements which emerge in each case, partly in order to determine the most appropriate action to be taken with regard to the credit institutions and the speed with which it should be pursued; moreover, the choice of measures is not restricted to special administration and compulsory liquidation.

This arrangement ensures that the task of supervision is performed in a consistent manner; it has always been applied by the Governors of the Banca d'Italia in their relations with the judiciary as well as with other authorities.

For a long while it was possible to maintain that there were important reasons of a legal and banking nature for avoiding the "commotion" which would have been caused merely by submitting irregularities that might constitute criminal offences to examination by the judiciary. However, the change in the situation of the banks and in the general circumstances prompted the Banca d'Italia in 1970 to institute a procedure for assessing information gathered in the course of supervision; this was done with the full knowledge of the judicial authorities. The procedure lays down that, when it must be established whether conditions are such that the requirement for confidentiality should be waived with respect to the judiciary, the information collected shall be examined by an advisory committee composed of the heads of department and the central manager of the supervisory authority, who acts as chairman, and assisted by a member of the legal staff.

The committee's assessment also takes account of the banks' comments on the facts that have emerged. The reports examined, the conclusions reached and the reasoning behind them are recorded in the minutes, which are submitted to the head of the Bank's Legal Service for an opinion. The minutes containing the committee's proposals and the legal opinion are both passed to the Governor for decision.

The procedure complies with the need to ensure that all cases are treated equally, since they follow the same path and the assessments are made by the same bodies. The outcome is based on the wide-ranging technical knowledge and professional experience of executives who are sensitive to the problems relating to the efficient and orderly functioning of the credit system by virtue of their full-time involvement with the task of supervision.

The Governor receives the strength and the stimulus to take action from the very fact that he alone is responsible for taking decisions and is not immune to initiatives by other branches of the State, as well as from the respect that the institution over which he presides and the banking system as a whole can command and maintain. The institutional contacts that may be established as required between the Governor and other political and judicial authorities were provided for by Parliament in order to strengthen his position.

As far as the relations between the Bank, as supervisory body, and the judicial authorities in particular are concerned, we are confident that the Governor will be vindicated in his conviction that the power of supervision over banks is granted not so that inquiries can be made to detect criminal acts or make it easier to prevent them, but in order to gather information of use to the Bank in pursuing its own public objectives on the basis of constant consultation with the Government; that the legislation does not and cannot prescribe that the bank supervisory authorities should act as a special police force, with autonomous powers to decide what inquiries should be undertaken; that the banks must not receive worse treatment than other firms, which cannot be subjected to investigation except upon the instructions of a criminal court judge; that it is the responsibility of the Governor to establish whether a case should be referred to the judicial authorities, insofar as this is compatible with the fundamental requirement to safeguard credit operations; that the obligation to maintain banking secrecy should be observed by all the organs of the State without exception, in compliance with the principles laid down in the Constitution.

We wish to request that, without in any way curtailing the duties and responsibilities of the Governor, this high official be allowed to operate without the natural doubts about decisions being compounded by paralyzing uncertainty as to the extent of his powers.

Ladies and gentlemen,

Recent news reporting has focused considerable attention on the events we have just described and on the problems involved. It would only cause injury to the economic structures and to the individuals concerned if it did not lead to an understanding of the profound crisis affecting the criteria and institutions employed for government intervention in the Italian economy and if it did not stimulate the examination and establishment of better, more consistent arrangements.

In 1933 the most severe economic, financial and industrial crisis of the first half of this century gave birth to the Institute for Industrial Reconstruction (IRI), a temporary agency designed to support ailing industries as a means of restoring the banking system to health. The transformation of the IRI into a permanent institution four years later gave rise to the system of state shareholdings as a means of attaining self-sufficiency in the fundamentally closed economy of a country that was already at war. Immediately after the war the granting of credit concessions was chosen as the way of distributing the cost of development and work creation in the less prosperous regions over the nation as a whole. Towards the middle of the sixties, by which time the economy was highly open and integrated into the European Community, the Government set itself the task of making the initial evaluation of individual projects as well as establishing general guidelines. At about the same time employment came to be protected not only by fostering development and creating the necessary public services but increasingly by making labour relations inflexible and subsidizing companies unable to survive unaided. None of these measures replaced or modified those that had gone before.

Since 1973 the most serious economic, financial and industrial crisis since the war has brought to light the hidden danger of such an overlap in the range of measures, revealing how inflexible and precarious was the edifice that had been constructed, how uncertain the distinction made between market factors and administrative factors, between social requirements and industrial requirements, between the management of public property and the exercise of supervision, between the taking of risks and the desire for guarantees, between the public sector and the private sector and among political control, economic control, administrative control and judicial control. Italy will be able to overcome this crisis in the criteria for economic management only if the fundamental rules governing its mixed economy are subjected to fresh, systematic scrutiny, if state intervention in the economy is reappraised in order to define its direction, methods and not least its extent, and if wisdom is exercised in both the economic and legal fields.