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THE GOVERNOR'S
CONCLUDING REMARKS

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III. - THE GOVERNOR'S CONCLUDING REMARKS

Last October Paolo Baffi carried out his intention of relinquishing the office of Governor of the Bank "before the turn of the decade". The Board of Directors has appointed him Honorary Governor.

Professor Baffi's service at the Banca d'Italia stretches over a period of more than forty years, for twenty of which he was a member of the Directorate. His work has had a far-reaching influence on the Bank throughout the second half of its existence.

In March 1936 the Research Department managed to tempt him away from what promised, under the guidance of no less an economist and statistician than Giorgio Mortara, to be a brilliant academic career. From that moment on, without interlude, his contribution to the Bank has been of the highest value, combining technical expertise, keen analytical powers, moral stature and great discernment in the monetary management of the economy. The marks of his influence reflect the three stages of his activity at the Bank: that of economic analysis and counsel, that connected with the duties of Director General, and that of monetary and credit policy in his capacity as Governor. Among them, however, one may be noted in particular because it epitomizes and, one might say, is the source of all the others. Paolo Baffi's influence has been paramount in bringing to the Banca d'Italia the discipline of a method and hence of a style: the method whereby the soundness of a judgement, the validity of a choice and the proof of a strategy are measured solely on the basis of the coherence of the underlying logic, the wealth of supporting arguments and the reliability of the information on which they are founded or by which they are substantiated.

Professor Baffi himself confirmed the value of strict adherence to this method through outstanding analytical and practical contributions from his first years in the Research Department. Under his direction economic research at the Bank was given new impetus in the post-war decade. The organizational framework of the Research Department was then consolidated; in particular, a fundamental approach was established, founded on the principle of the complementary role of theoretical and applied research. The refinement of the techniques of analyzing the determinants of the money stock and flows of funds, the ready adaptation to national accounts systems used abroad, the close attention dedicated to international economic and financial issues, the care devoted to the statistical accuracy and linguistic standards of the documents produced - these are some of the features of the work of the Research

Department established in that period and later successfully reconciled with the expansion of the Department and the development of new techniques and procedures.

Between 1960 and 1975, when he was Director General in charge of the internal management of the Bank, Paolo Baffi and Governor Carli together formed a managerial team of exceptional distinction, whose prestige grew with the years. This was a time of growing problems for the Italian economy, culminating with the emergence of what is increasingly termed the international crisis of the 'seventies. Paolo Baffi himself deserves the twofold tribute that he addressed to Guido Carli in the early pages of the Governor's Concluding Remarks in the Report for 1975: of having brought an important contribution to the international economic policy debate and of having employed the instruments of monetary and foreign exchange policy to best effect.

In August 1975 Professor Baffi became Governor, shouldering the burden of conducting monetary policy in a period in which the destabilizing forces within the international and domestic economies were lying dormant, only to re-emerge the following autumn and winter, revealing the precarious nature of demand expansion when the structural constraints that shackle an economy are not confronted. In January 1976 these forces reduced the foreign exchange reserves to 600 million dollars; in May they brought the exchange rate against the dollar to Lit. 916, and in February-May pushed the monthly rate of inflation above 2 per cent. The banking incidents in the United Kingdom, the Federal Republic of Germany and the United States, in some cases traumatic, had also demonstrated that economic stagnation, stock-market fluctuations and currency unrest had raised, in the most pressing terms, the question of the stability of the financial intermediaries and consequently their surveillance by the supervisory authorities.

Once the worst of the crisis had been overcome with the introduction of a series of economic, credit and foreign exchange measures, Professor Baffi succeeded during the following three years of persisting problems in grasping every opportunity for further stabilization offered by the steadier, albeit modest, growth of world demand and the relative moderation of the increase in the price of oil.

With the objective of securing lasting external balance and an adequate rate of utilization of productive potential, exchange rate management was combined with demand restraint in the mix necessary in an economy with widespread income indexation and a high degree of downward price rigidity, in particular in those sectors not exposed to international competition. By the end of 1978 inflation had been brought

back down close to the threshold of the long-term structural component and the short-term imported component. From 1977 a comfortable balance-of-payments surplus was achieved, making it possible to meet external debt-servicing commitments equivalent to 13 billion dollars in the three-year period 1977-79, as well as build up the foreign exchange reserves. This progress on the inflation and balance-of-payments fronts was achieved without complete stagnation; though still inadequate in terms of the country's social needs, real GDP growth was not much below that for the OECD area as a whole.

Domestic monetary stabilization meant that Italy was ready to join the European Monetary System on the appointed date. It is thanks to Professor Baffi's untiring and fruitful efforts that the terms of participation most closely accord with durable progress in forging a European entity and at the same time with Italy's capacity to form a stable element in that process.

The imbalances that have re-emerged on the world economic and political scene make it a heavier but also more compelling obligation to undertake every effort to ensure that the progress Professor Baffi's endeavours have helped to achieve is not wasted. The advances made may prove to be short-lived if we do not utilize the margins still left, in terms of time and resources, for a co-ordinated attempt to tackle both short and long-term economic problems.

The events that preceded Paolo Baffi's resignation as Governor leave us with another, no less demanding responsibility. They have given substance to the twofold misgiving that in Italy the scope for individuals of great competence, moral integrity and respect for the established institutions has become more confined, and that the tradition of central bank efficiency and autonomy may be undermined. We are conscious that it is also one of the Bank's tasks to dispel these misgivings through its own conduct.

It can do so precisely by adhering to the method of strict ethical and professional discipline that Paolo Baffi's influence has helped to establish. The Banca d'Italia has consistently applied this method and disseminated it throughout its organization, deriving lasting benefits in terms of the ability to make a qualified and independent judgement, and hence of operational autonomy within its institutional competence.

The Bank has been able to confront the particularly serious problems and formidable tasks presented by domestic and international economic developments over the past year by drawing on those values that are the result of the high professional and moral standards set by the generations that have served it, values that are also the guarantee to the country at

large of its proper functioning. Despite the feelings of great unease and, at times, bitterness there has been no lessening of devotion to duty.

The Bank's normal activities have continued without pause and technical and organizational innovations have been adopted, some of considerable importance. Collaboration with government bodies, international institutions and research centres has certainly been no less in demand and no less active than in the past.

For this the Directorate, to which the new Director General, Lamberto Dini, has brought his invaluable expertise and long-standing international experience, wishes to express its grateful recognition to the management and the entire staff.

In performing its institutional functions in times of rapid change the Bank will be aided by the recent agreements reached with the trade unions. They open the way for the numerous innovations that can enrich, and be enriched by, the Bank's established traditions.

The new oil crisis

Following the 1974-75 recession and the recovery in 1976 the OECD countries experienced three years of growth at a rate of just under 4 per cent, accompanied by an average rate of consumer price increase of over 9 per cent. 1980 opened in a climate of slower growth and accelerating inflation. A major contributory factor to both of these trends was the further increase in the prices of primary commodities, in particular that of oil which more than doubled between the end of 1978 and the early months of 1980.

The new oil price rise has once again raised three pressing problems: the inflationary consequences, with a severe direct impact and dangerous secondary repercussions as attempts are made within the importing countries to recover the loss in real incomes and escape the oil levy; recessionary pressures, resulting from the gap between the transfer of resources to the OPEC countries and their capacity to import, which in 1980 will produce a current account surplus for the OPEC area of around 120 billion dollars; and finally, the implications for the international monetary system of recycling such a huge volume of funds.

The immediate economic policy response of the major industrialized countries was to counter inflation, primarily through the use of monetary policy and exchange rate support.

The rise in interest rates began in the Federal Republic of Germany and soon spread to other countries participating in the European Monetary System, starting with those with weak currencies. The movement escalated when it reached the United States, where historical peaks were recorded first in October, with the introduction of a package of measures to secure closer control of the monetary aggregates and to ease pressures on the dollar, and again in March this year, when monetary policy was temporarily tightened further.

A cyclical turnaround of the US economy was expected, after four years of expansion and worsening inflation since the summer of 1978. It was, however, anticipated that the role of sustaining global demand would be taken over by growth in Europe, Japan and the developing countries. Given the unexpected strength of the US economy in 1979 there is now concern that the incipient recession will coincide with the slowdown in the other industrialized countries, most of which have adopted policies of demand restraint.

In this scenario of stagflation orderly recycling becomes crucial in order to ensure that the oil deficits can be financed without giving rise to excessive international liquidity creation.

After the 1973 oil crisis the financing of the deficits proved to be more manageable than had been foreseen. In 1974-79 the international banking sector intermediated over a third of the OPEC current account surplus, meeting almost half of the net financing requirements of the developing countries. Moreover, the surplus itself was fairly quickly absorbed, in part because the prices of manufactured goods made up ground vis-à-vis that of oil. This time recycling promises to be a more intractable and longer-term problem, even though, by contrast with the earlier crisis, within the OECD those countries starting out with the largest deficits are those that are in the best position to finance them. OPEC's new supply policy makes it unlikely that the 1975-78 decline in the real price of oil will be repeated. Furthermore, a number of the developing countries face grave difficulties in servicing the debt they have already accumulated, while the international banking community itself perceives the risks connected with capital inadequacy and the concentration of the demand for and supply of funds among small groups of countries.

In these circumstances the international institutions will have to play a greater role in financing the deficits, combined with more clearly defined adjustment policies. Joint initiatives with the private banking system could prove valuable.

The prompt action taken in most countries to restrain monetary expansion was necessary, not least to counter a wave of destabilizing expectations. But its cost and, indeed, its effectiveness very much depend on the determination with which economic policy is turned to tackling the structural constraints that, both within individual economies and between groups of countries, remain the chief obstacle to the restoration of lasting growth.

The expansion of the world economy in the 'fifties and 'sixties occurred in an environment which reflected the paradigm of reproducibility. In a climate of falling relative prices for energy and primary products, production and demand were geared to increased consumption of basic resources. The past decade, on the other hand, has seen a shift towards conditions corresponding to the paradigm of scarcity, brought about by limitations on the supply of natural resources.

Furthermore, since the end of the 'sixties far-reaching changes have taken place in the labour markets and in labour relations, with the result that the growth in money wages has far outstripped that in productivity and has become less responsive to sectoral productivity differentials.

The pressures from primary product prices and nominal wages have disrupted the whole system of relative prices. The downward rigidity of prices and incomes linked with the spread of oligopolistic market forces has meant that the dramatic changes in relative prices have not been expressed in movements in absolute money prices in opposite directions but in a general upward trend. For the same reasons, exchange rate instability has had an asymmetrical and therefore globally inflationary impact on prices: in countries whose currencies have depreciated the acceleration of inflation has been greater than the deceleration that has occurred, with a decline in employment, in those countries whose currencies have appreciated.

The predominance of the price component of income growth over the real component is not a recent phenomenon: it has been made possible by an elastic money supply and has been a feature of the whole of the last decade, in contrast to the preceding twenty-year period.

The structural, and apparently sticky, threshold of inflation varies from one country to another. Its level is determined by differences in the direction and scale of changes in the terms of trade; in the degree of imbalance between the structure of demand and that of production; in the strength of wage pressures and their compatibility with productivity patterns; in the prevalence and forms of income indexation; in the structure of public sector finances and the mechanisms of State

intervention in the economy; and in the extent to which supply can meet peaks in demand.

Among the objectives of economic policy lowering the threshold of inflation is no less essential, if less quickly attainable, than eliminating the occasional eruptions beyond it. Only this will secure stable employment and restore the incentive to invest. Some countries have taken the path of restoring elasticity to the supply and price mechanisms, scrutinizing the public sector finances and productivity, using State intervention to promote the progressive sectors of industry rather than prop up those that are no longer viable, with the implication that the work-force shares the fortunes of the company. Money supply control, to prevent excessive overall spending, has been the corollary of these remedial efforts. They are most likely to succeed if they are pursued without dogmatic inflexibility, with singleness of purpose and with perseverance.

The alternative to this approach is to remain permanently at the mercy of scarcity and to rely simply on demand management, squeezing the economy into the straitjacket of stagflation.

The industrialized countries must progressively escape from these constraints, by changing life-styles and the processes of production and developing their own sources of energy; but it is equally essential that they make every effort to reach a common understanding with the OPEC countries and the developing nations to ensure that a growing volume of petro-funds is channelled towards the developing world. This three-cornered relationship, linking technology and industrial goods, energy sources and primary products, would constitute a huge area with a common interest in the expansion of world trade, and therefore in the stability of exchange rates and of the international monetary system. The EEC itself can make a valuable contribution towards this goal, with the benefit of its economic, political, geographical and traditional links with the developing countries.

International liquidity

In the course of the 'sixties official international liquidity expanded by 40 per cent, reaching 80 billion dollars at the close of the decade; by the end of 1979, with the gold component valued at market prices, it had increased tenfold to stand at 830 billion; gold now accounts for almost 60 per cent of the total, compared with 50 per cent ten years ago. This explosion of international liquidity has been accompanied by changes in its composition and in the processes by which it is created and absorbed.

Between 1970 and 1973 the chief source of liquidity was the US balance-of-payments deficit, and reserve accrual, in dollars, was concentrated predominantly in the industrialized countries.

Since 1974 official reserve holdings have been boosted by the build-up of liquid balances with the international banking system by the OPEC countries. In addition, the growth of compensatory borrowing in the international financial markets has been accompanied by partial redepositing of the proceeds by the monetary authorities.

The main developments in 1979 were the sharp rise in the price of gold, the creation of ECUs within the EMS and the absorption of liquidity as a result of the decline in US official liabilities.

During the past decade international liquidity ease has led to a relaxation of the prudential criteria governing bank lending, a growing proportion of which has been taken up by the developing countries. The results have been increased maturity transformation, larger individual loans, not necessarily linked to specific investment projects, and a narrowing of operating margins to levels considered by some to be too low. Easier borrowing conditions have delayed adjustment, allowing inflationary pressures to persist, and have heightened the risks for the international banking system.

The central banks of the Group of Ten countries have agreed, in discussion at the Bank for International Settlements, to implement banking supervision on the basis of globally consolidated accounts, paying particular regard to the banks' capital adequacy, liquidity, maturity transformation and the concentration of risks. For this purpose it was felt that more detailed and up-to-date statistics on international banking operations were essential. It was also agreed that it would be desirable gradually to reduce the institutional competitive advantages of international banking activities and to monitor closely the development of the international financial markets and their significance for, and how they are affected by, domestic monetary policies.

A further area of concern is the trend towards diversification of official reserves. The movement took on significant proportions chiefly as a result of the search by the oil-exporting countries for adequate investment outlets for large volumes of relatively long-term funds in an environment of inflation and uncertainty, following losses on their dollar assets. It was amplified by other countries, some with only small, or even negative, net reserves but large gross liquid balances. Finally, exchange rate flexibility itself was an inducement to holding multi-currency reserves more closely reflecting the currency structure of imports.

The trend was moderated by the major industrialized countries, which informally agreed not to diversify their reserves through the Euro-currency markets. In addition, on the supply side, the German, Japanese and Swiss central banks took measures to discourage the acquisition of domestic official liabilities by foreign monetary authorities. This policy has now changed with the negative shifts in their external accounts, opening up the possibility of direct financing of the deficits, thereby reducing the recycling burden for the international capital markets.

The interplay of factors encouraging diversification and those working against it have led to fluctuations in the currency composition of international reserves. There has not, however, been a significant contraction in the dollar component, which between 1970 and 1978 remained fairly stable at around 75 per cent; in 1979 it declined by over ten percentage points, but chiefly as the book-keeping counterpart of the creation of ECUs. The share of the German mark rose over the decade from 1.5 to 11 per cent, while that of sterling contracted; assets in German marks at present amount to the equivalent of some 35 billion dollars, about two thirds of which are held in the international financial markets.

The benefits to be gained from a co-ordinated approach to the issue of reserve diversification have revived the earlier proposal of creating a dollar/SDR substitution account at the International Monetary Fund. Notwithstanding the progress made, problems remain in connection with the apportionment of potential losses in the event of a depreciation of the dollar vis-à-vis the SDR that is not offset by an adequate nominal yield differential between the two assets.

A combination of factors, including the acceleration of inflation, exchange rate uncertainty and international political tensions, triggered the sharp climb in the price of gold, which then fed on itself. The price per ounce soared from 260 dollars in June 1979 to a peak of 850 dollars last January, subsequently falling back, with wide fluctuations, to around 500 dollars. With official gold holdings of around one billion ounces, the value of official international reserves consequently recorded an unprecedented increase.

The very instability of the gold market seems to rule out renetization of the metal; the re-establishment of a gold pool by the Group of Ten central banks could, in the face of erratic behaviour by resident and non-resident holders and buyers, transform the system of orderly intervention on the gold market into a mechanism that could not be fully controlled, with negative repercussions on domestic and international liquidity management.

The course that must be taken is that already noted, of striking with greater determination at the roots of inflation, both domestically and through active international co-operation, and of restoring currency confidence. Pending the achievement of greater stability, the question of the role of gold in official reserves will require a pragmatic approach, with international co-ordination to promote its mobilization, drawing also on methods already used.

The European Monetary System and the exchange rate

The first year of operation of the EMS can be considered satisfactory when measured against the objective of securing greater cohesion of participating currencies.

In establishing the System the European Council had also looked forward to broader goals, including the promotion of monetary stability and balanced growth as a basis for relaunching the process of European economic and monetary union.

In this respect, progress was inevitably affected by the far-reaching changes on the world economic and financial scene. There was no advance in economic convergence and no reconciliation of views regarding the role of the Community budget and the implementation of reforms agreed in principle.

The intention of steering the budget more effectively towards narrowing regional income disparities, strengthening economic potentials and, in short, promoting lasting monetary stability has been squeezed between the lack of autonomous sources of Community finance and the demand on resources for regulating the agricultural markets. Steps must be undertaken to loosen at least one jaw of the vice.

The conflict of views on the Community budget was an obstacle to Community-wide participation in the exchange rate mechanism. Significant advances have been made in the operation of the exchange rate arrangements, thanks in part to collaboration between the central banks in their daily contacts.

Two aspects in particular have been the subject of intensive debate: the definition of an intervention policy vis-à-vis the dollar and the evaluation of the functioning and role of the unilateral indicator of divergence vis-à-vis the ECU. These two problems could not be resolved on the basis of a fixed set of rules and procedures while the range of inflation rates, rather than narrowing downwards, was in fact tending to widen upwards. In these circumstances the intervention policies actually

pursued, especially vis-a-vis the dollar, were bound to reflect the sometimes conflicting requirements of containing inflation and countering the centrifugal pressures within the exchange rate mechanism, signalled by the indicator of divergence.

With specific reference to the movement of the dollar against the ECU, experience with the EMS can be divided into three phases. Between 13th March and early June the Deutsche Bundesbank undertook large-scale sales of dollars in the market in order to counter the appreciation of the US currency and check imported inflation. During this period, while the problems of the weakest EMS currencies worsened, the lira, supported by a large balance-of-payments surplus, became the strongest currency. Intervention purchases of dollars were necessary to prevent the upper divergence threshold from being reached, notwithstanding the 6 per cent margin.

The second phase, coinciding with the decline of the dollar, covers the period up to 23rd September, when the first realignment of currencies took place and the German mark was revalued. As part of their counter-inflationary policy the German authorities were tightening interest rates. The lira, still fundamentally firm during the summer, showed signs of weakening in the second half of September as a result of seasonal factors and capital movements caused by the erosion of interest rate differentials.

In the last eight months, apart from the devaluation of the Danish krone at the end of November, cohesion within the EMS was maintained both through differential increases in interest rates and through exchange market intervention in Community currencies and, on a larger scale, in dollars. The main purpose of these interventions was to moderate the upward pressure on the dollar in the wake of the improvement in the US external accounts and the measures taken by the Federal Reserve, which triggered the spiralling of interest rates during the first quarter of 1980. More recently, the decline in US rates and the stabilization of European rates at high levels, or indeed their further rise, together with renewed political tensions, have led to a recovery of EMS currencies, in particular the French franc, which moved to the top of the EMS exchange rate band.

In this third phase the lira weakened not only against the dollar but also in terms of the ECU. This reversal, which in recent months has taken the Italian currency into the lower segment of the EMS band, coincided with the deterioration in the balance of payments, which in the six months from October 1979 to March 1980 registered an overall deficit of 2,100 billion lire, compared with a surplus of 2,300 billion in the corresponding period a year earlier. The deficit was financed by increased foreign borrowing by the banking system. The next forty-five days closed with an

overall deficit of 950 billion lire, with an almost equivalent inflow through the banking system.

While the experience of the first fourteen months' operation of the exchange rate arrangements can be considered broadly positive, lasting progress in monetary and financial convergence and in exchange rate stability will only be possible if the domestic causes of inflation differentials are brought under better control.

There has been discussion at both technical and political levels of the question of consolidating the existing provisions and procedures governing the exchange rate and credit mechanisms into a definitive system via, *inter alia*, the full utilization of the ECU as a reserve asset and means of settlement. The transition to this final system, entailing the formal and effective creation of the European Monetary Fund, was envisaged within two years after the start of the System.

A number of alternatives have been outlined regarding the functions and consequent structure of the Fund. It is our firm belief that, as a contribution to European integration, the monetary role to be assigned to the Fund should include the most immediate and important functions of extending the role of the ECU and analyzing and co-ordinating monetary and exchange rate policies both within the EMS and vis-à-vis the dollar.

The complexity of the legal and institutional problems involved will depend on the scope of the powers it is intended to place with the Fund, and they will no doubt require time to resolve. Moreover, the need for parallelism in progress in monetary and in economic integration means that sharp differences in pace between the two must be avoided.

In the present climate of international economic uncertainty the necessary qualitative jumps must not be tied too rigidly to a predetermined timetable which might prove too tight and thereby risk undermining the foundations of the definitive system.

The domestic economy

The large current account surplus, which at 4,250 billion lire was only slightly less than in 1978, provided a basis not only for keeping the external value of the lira stable but at the same time reimbursing 2,050 billion of compensatory borrowing and improving the net official external position. By contrast with the previous year, however, the surplus stemmed mainly from tourism, since the visible trade balance swung from a surplus of 2,450 billion lire to a shortfall of 850 billion. This swing on merchandise trade account, which was first registered in the third quarter

and took the whole current account into deficit in the fourth, was due to the progressive worsening of the oil deficit, which widened by 2,150 billion over the year, to the steady rise in domestic demand and the erosion of competitiveness as a result of the sharp acceleration in inflation.

Imports rose almost three times as fast as gross domestic product, which expanded by 5 per cent in real terms and by 21 per cent at current prices. However, exports were also once again a major component of the growth of overall demand and, despite considerable production losses through industrial disputes and a generally high rate of capacity utilization, Italy's share of world markets rose further to 7.2 per cent, compared with 5.9 per cent in 1973.

The surplus on trade in manufactured goods owed even more than in 1978 to traditional industries such as textiles, clothing, footwear, skins and leather, whose positive balance moved up from 6,450 billion lire to 7,700 billion, overtaking that of the mechanical engineering sector. The position of two industries in crisis worsened: the deficit of the chemical sector widened from 1,250 to 2,150 billion, while the small surplus of the basic metals industry was transformed into a deficit of 1,350 billion. The changes in sectoral balances are reflected in the composition of trade: in particular, the proportion of total exports accounted for by the traditional industries rose from 18.5 to 19.1 per cent, while that of mechanical engineering fell from 25.2 to 23.8 per cent and that of basic metals from 9 to 8.2 per cent, confirming the decline of the more capital intensive sectors.

In the years that followed the first oil crisis, a combination of slow growth, the world crisis affecting sectors that are major capital investors, unpredictable market developments, limitations on the flexible use of plant and the public sector's growing demand on financial resources led to a marked decline in fixed capital formation. The risk element associated with the rise in fixed costs caused a great many large and medium-sized firms to delay modernization and expansion, with the result that the industrial base was strengthened only by companies whose type of product and size enabled them to increase capacity rapidly and with modest capital outlays. The ratio of investment to income fell from 25 per cent in the 'sixties to 21 per cent in the 'seventies and now stands at 19 per cent — 2 percentage points below the OECD average.

With the improvement in profits and capacity utilization rates, fixed investment picked up last year, though the rate of growth was no higher than that of gross domestic product. The recovery was confined chiefly to the private corporate sector, whereas the scale of public investment remained modest. While the sluggishness of public investment may be less serious in a year of steady expansion, institutional shortcomings and

a lack of co-ordination between central and local government deprive economic policy of a basic instrument with which to regulate and strengthen the economy.

Consumption accounted for much of the growth in demand. The sharp increase in disposable income in the last few months of 1978, followed by new wage settlements and a steady increase in hours worked, encouraged higher personal spending, while in a climate of rising inflationary expectations planned purchases of consumer durables were brought forward.

The growth in output halted the uninterrupted decline in industrial employment since the second half of 1977. However, the improvement was not fully reflected in the employment figures because of the wide margins of underemployment of existing labour forces. On an annual average basis and excluding the construction sector, industrial productivity per man-hour rose by about 8 per cent. Nonetheless, the average rate of productivity growth in the last five years came to only 3 per cent, against 8 per cent in the previous five-year period. By comparison, among the other major industrialized countries the sharpest deterioration between the two periods was the slowdown from 8 to 5 per cent in Japan, while France at the other end of the scale registered a decline from 6 to 5 per cent.

This poorer productivity performance has been due not only to the slowdown in economic growth but also to inadequate capital investment, economic obsolescence caused by the change in relative prices and rigidity in the employment of productive resources. Furthermore, this last factor, by preventing the optimum utilization of plant, leaves little room for holding down costs through additional, more productive investment. This itself deters new investment and the vicious circle is complete.

In the second half of 1979 multiplier-accelerator effects were pronounced. Compared with the depressed levels of a second quarter crippled by labour disputes, in the fourth quarter gross domestic product rose by 5 per cent, industrial output by about 7 per cent, investment in equipment and vehicles by 20 per cent and imports by 12 per cent. At the same time industrial employment showed a rise of 1.5 per cent, hours worked per employee one of 3 per cent and productivity per man-hour one of 2.5 per cent. The upturn continued in the first quarter of 1980, with a further 3 per cent increase in production, while the current account deficit widened, according to provisional estimates, to about 700 billion lire on a seasonally adjusted basis.

The fear remains that the encouraging results in terms of production, employment and investment in the second half of 1979 and

the first few months of this year may prove to be short-lived, not only because of the more pessimistic outlook for world demand but also because they were achieved in a climate of accelerating inflation. For the economy was hit by an extremely violent resurgence of inflation last year, even though, by comparison with the peaks recorded in 1974 and 1976, the role of the exchange rate was marginal and wage-push factors were much less pronounced.

Between December 1978 and March 1979 the rise in wholesale prices, which had been running at an annual rate of 8-9 per cent since the second quarter of 1977, doubled as a result of the tripling, from 13 to 40 per cent, of the rate of increase in industrial commodity prices, with non-oil products in the lead; from the summer onwards higher oil prices became the predominant factor. The inflationary repercussions of the sharp rise in the cost of imported raw materials were compounded early in the year by the fact that cost increases were more quickly passed on to the prices of manufactured goods, which were themselves rising on world markets. In the autumn the effects of high and rapidly rising rates of capacity utilization, especially in the consumer goods industry, also began to make themselves felt. At the end of the year both the general wholesale price index and that for industrial products were 20 per cent higher than twelve months earlier, while the non-food retail price index was 23 per cent up.

The rate of price increases for Italian manufactured goods progressively outpaced that of major competitor countries. With the effective exchange rate declining by 4 per cent year on year but stable over the year, this led to a loss of competitiveness of 1 per cent on an annual average basis and one of 7 per cent between the end of 1978 and the end of 1979.

The increase in the prices of industrial manufactures continued at an even faster pace in 1980, while consumer price rises have shown signs of slowing down since March.

In the first quarter of this year the overall development of production, prices and the balance of payments indicated that the economy was still expanding fast under the stimulus of domestic demand. The rate of capacity utilization was equal to the high recorded at the peak of the 1974 expansion. On merchandise trade account, apart from the negative impact of the repeated raising of oil prices, there was a substantial deterioration in the balances on transactions with the main industrial countries, and especially those of the EEC, owing to a substantial increase in imports and a weakening export performance.

The roots of inflation

During the second half of the 'seventies the annual rate of consumer price increase was at no time less than 8 per cent in the OECD, 5 per cent in the European Economic Community (excluding Italy in both cases), 3 per cent in the Federal Republic of Germany, 9 per cent in France and the United Kingdom — and 12 per cent in Italy.

These figures suggest that in the Italian economy the effects of destabilizing pressures are more severe or are more liable to result in protracted inflation.

Even though its share in total energy sources has been reduced through substitution by natural gas and coal and savings in consumption, a high dependence on oil continues to make the economy especially vulnerable to increases in its import price. In fact, oil still accounts for 68 per cent of energy consumption, a proportion similar to that in Japan but considerably higher than the 54 per cent in the Federal Republic of Germany, 48 per cent in the United States and 46 per cent in the United Kingdom. The position of dependence on foreign sources for non-oil raw materials is no less acute and offers no better prospects for the future.

When their relative prices are rising, the economic weight of primary commodities has an inflationary impact not only directly but, in two ways, via the deterioration in the terms of trade. The worsening of the trade balance leads to a decline in the exchange rate, producing further inflationary pressures and forcing a reduction in the rate of economic expansion. Slower income growth aggravates conflicts over its distribution, discourages investment and curbs improvements in productivity, thus making it more costly to transfer real resources abroad.

Imported pressures have been compounded by those of domestic origin. Since 1969 labour market developments and changes in industrial relations have triggered and sustained an increase in money wages that has been much faster than in other countries, even taking account of productivity patterns. In the last decade there has been an annual increase in industrial unit labour costs of 15 per cent, more than twice the average for the main industrialized countries.

The consequent relative price pressures and accompanying inflationary and recessionary repercussions are accentuated by factors specific to the Italian economy.

Economic dualism — regional, sectoral and dimensional — is pronounced. However, institutional and wage structures do not take due account of this fact but have, on the contrary, been made more uniform

over the years in the mistaken belief that the dualism can thereby be rectified.

Indexation of nominal incomes is high and affects relative income positions. In response to the deterioration in the terms of trade attempts are made to preserve living standards by escaping the inevitable transfer of resources, and to attain the unattainable objective of offsetting the loss in real income through increases in money incomes instead of seeking an equitable distribution of the costs in order to contain inflation.

The Italian economy has also been slow to react to the factors of destabilization because the rules of the economic and institutional game have become blurred. The signals that the market and the public sector transmit to consumers and producers have become less clear; producers in turn have become less responsive in directing investment choices towards new types of product and technologies; and finally, it has become harder to translate such choices into action. The very large firms are handicapped by limitations on manpower flexibility, compulsory employment, a reduction in working hours without a corresponding cut in costs, large debts and intervention by the public authorities that has crystallized elements of inefficiency.

The need to adapt to shifts and fluctuations in demand and exploit the competitive advantages offered, *inter alia*, by the depreciation of the lira, in a time horizon shortened by uncertainty, has prompted decentralization towards smaller units of production in an attempt to loosen the rigidities that sustain inflation.

The employment of techniques and organizational methods that are often highly productive, greater freedom in the use of manpower, the ability to respond quickly to a shift in market preferences, the closer link between the company's prosperity and wage improvements for its workforce, together with simplified decision-making procedures have enabled small businesses to outgrow the subordinate role of cushioning the cyclical problems of large companies and win a place of their own even on world markets. Indeed, much of the success of the country's exports is due to them.

These are positive developments, though they cannot be expected to solve the underlying problems of Italian industry. But economic and administrative cost pressures have also had adverse effects, encouraging the circumvention of regulations and creating a new form of dualism in the economy. On the labour supply side this has been the outcome of long-term unemployment, the taking of second jobs, frequently accompanied by a tendency to view the formal job as a source of welfare benefits, in some instances worker preference for more flexible duties and hours, and the

bite of inflation. The so-called underground economy is a response that should not be ignored, not least because it can represent a reaction to over-severe constraints and a lack of understanding of the social and economic realities. It cannot, however, be the basis for renewing the industrial apparatus, not only because it narrows the perspective of initiative but also because it offers solutions that the community cannot in the long run accept.

Public sector expenditure and the methods by which it has been financed have also been among the causes of the high rate of inflation.

The fact that general government has made a late and limited contribution to a better utilization of resources is principally due to the quality of expenditure. In addition, the public purse has had to bear the cost of resolving conflicts over income distribution and finding the means to compensate for, rather than rehabilitate, the unprofitable areas of production. Coming on top of existing trends, this has led to a rapid increase in spending, especially on current and capital transfers. Between the beginning of the 'sixties and the last two-year period the ratio of spending by general government and autonomous government agencies to gross domestic product rose from 32 to 47 per cent, with the rate of growth accelerating in the 'seventies. In the same period outlays on social services increased from 12 to 20 per cent of GDP; in particular, the cost of the pension system rose from 6 to 12 per cent and that of the health service from 3 to 6 per cent.

The provision of public services has expanded, particularly in the field of education and hospital care, as has the number of employees. During the 'seventies the public sector as a whole employed over 900,000 people, that is, about two thirds of the new labour force. This expansion, however, does not appear to have been accompanied by an increase in efficiency, or by any appreciable improvement in the quality of the services provided. Although the ratio between fiscal revenues and income increased from 26 to 33 per cent, between the early 'sixties and the last two years the public sector's current balance moved from a surplus equivalent to 3 per cent of GDP to a deficit of 6 per cent, while the overall deficit rose from 1 to 10 per cent.

Precisely because certain fundamental imbalances were corrected on a provisional basis only, with public financing and with little regard for economic criteria, they have been perpetuated and have rooted inflation firmly in the economy.

The volume of credit and liquid assets that had to be created to meet the large public sector borrowing requirement, which has sometimes considerably exceeded budget estimates, and at the same time to ensure

that private sector production and investment were not crowded out has resulted in a growth in income in which the major element has been the price component. The large volume of financial assets held by households has led to a substantial redistribution of wealth towards the public and corporate sectors, since the tax levied by inflation is the least likely to be offset by higher personal income demands.

The recent and past components of price movements, which combine and merge into current inflation, have been analyzed individually only so as to provide a guide to the steps to be taken.

In the last half of 1979 the acceleration of inflation, the steady expansion of production, the emergence of pressures on the exchange rate and the repercussions of international economic developments formed the background against which the restrictive monetary measures described in the following section were formulated and implemented from October onwards. Continued monetary policy action along these lines, supported by a consistent fiscal and budget policy, may be able to slow down the present rate of inflation. It cannot, however, achieve a degree of stability equal to the EEC average, which must be our goal.

If more far-reaching and lasting results are to be obtained economic policy must tackle the underlying factors that continuously induce a higher rate of inflation in Italy. The appropriate line of attack in each case, which must be followed gradually and with determination, is shown by the above analysis.

Regional development policy must exploit processes already under way and encourage labour intensive investment, steer firms towards branches of activity with high added value and promote efficiency rather than merely injecting subsidies. An energy consumption and investment policy must make energy production less dependent on oil and economic growth less dependent on energy consumption. Industrial relations must be established that allow productivity to be raised to levels compatible with the wish to safeguard jobs and firms. The underground economy must be brought into the open, not suppressed, and in particular there must be a policy for large businesses, which a modern industrial economy cannot do without and which must be subject to uniform economic rules whether they are publicly or privately owned. Indexation mechanisms must be moderated and more rational, and at least cease to reflect indirect taxation which can then resume its function as an instrument of economic policy. Public expenditure reduced to general European proportions must be matched by public services of a general European standard, and the deficit must be held within limits that are compatible with investment requirements and consistent with a policy that is truly counter-inflationary.

Monetary and credit developments

Last year monetary policy once again had to contend with the conflicting requirements of fostering the recovery in production and combating the acceleration in inflation.

The recent economic debate in Italy and abroad has revealed a wide range of views and conclusions with regard to the transmission mechanism, the effects of monetary policy on nominal income, and especially its impact on production and prices. There is, however, broad agreement that the uncertainties resulting from sudden and frequent course corrections and the time lags that occur before their effects are felt can in fact increase the cyclical variability of the economy instead of reducing it. Monetary policy therefore tends to be determined against a fairly long time scale on the basis of macro-economic forecasts. Consideration of the destabilizing effects that can result from following an erratic monetary course sets a limit to the constant revision of intermediate objectives; greater strictness in holding to quantitative targets means accepting larger movements in interest rates.

The quarterly report on the borrowing requirement of the enlarged public sector presented to Parliament by the Minister of the Treasury in March last year was based on the assumption that in 1979 gross domestic product would increase by 5 per cent, prices would rise by 14 per cent and that there would be a current account balance-of-payments surplus of 3,000 billion lire, smaller than that recorded the previous year but apparently the highest of any industrial country. These forecasts took account, in particular, of the weakening of world demand that was expected to occur during the year, mainly as a result of the anticipated recession in the United States.

The macro-economic framework was considered to be consistent with monetary base creation of 8,000 billion lire (net of postal deposits), a domestic borrowing requirement of the enlarged public sector of 35,200 billion lire and total domestic credit expansion of 53,300 billion.

The differential between the yield on short-term Treasury paper and the net return on bank deposits as well as the liquidity situation of the economy at the end of 1978 were such that in the first half of 1979 the public made net purchases of Treasury bills and Treasury credit certificates totalling 9,400 billion lire, compared with 6,800 billion in the whole of 1978. The total amount of government paper placed on the market during the first half of the year, including medium-term securities, came to 16,600 billion lire, about half of which was drawn from the Banca d'Italia's portfolio.

If the central bank had at that time kept the growth of the monetary base on the path initially set, interest rates could have been reduced. However, the target variable continued to be total domestic credit, which in the middle months of the year was slightly below the volume foreseen. Conversely, the strength of the lira within the EMS and vis-à-vis the dollar and the current account balance-of-payments surplus made it inadvisable to adopt a monetary policy that would lead to an increase in interest rates in the immediate future. Although the differentials between rates in Italy and those abroad were narrowing, they were still large, thus inducing an expansion in foreign currency borrowing; as a result, the banks' net external liabilities increased by more than 2,000 billion lire in the first half of 1979. During the same period the monetary base contracted slightly and the growth in the money stock decelerated markedly.

In the course of the year, as the magnitude of the oil shock and the extent of the tensions on raw material markets were revealed and demand showed more sustained growth, the monetary authorities in the main industrial countries reacted to the inflationary pressures by introducing measures aimed at preventing monetary expansion and credit growth from financing the spread of the increase in prices; as a result, interest rates rose further everywhere.

This trend was also apparent in interest rates in Italy. Initially the action taken by the Banca d'Italia on the domestic markets was aimed at encouraging an increase in medium and long-term yields. The reversal of the inflow of funds from abroad through the banks from June onwards increased the demand for loans denominated in lire, the supply of which was subject to the credit ceiling. In September the international markets came under increasing pressure, which led to the realignment of European currencies and the announcement of further measures by the Federal Reserve in the first few days of October. Italy's balance of payments began to show signs of deteriorating, the lira came under pressure, credit demand remained high and the monetary and credit aggregates began to diverge from the planned path, partly as a result of the public's temporary preference for bank deposits.

At the beginning of October the discount rate was increased by one and a half percentage points to 12 per cent; in the same month the ceiling on the growth of bank lending was extended until July 1980, the permitted increase in loans subject to the ceiling being set at an annual rate of only 10.6 per cent and the exemption threshold being raised from 100 to 130 million lire.

The acceleration in the rate of domestic price increases and the uninterrupted rise in interest rates abroad, which accentuated the pressures

on the balance of payments exerted by seasonal factors, made it necessary to raise interest rates again in December in order to avoid jeopardizing the strength of the lira and exacerbating inflation. The increase of three percentage points brought the discount rate back to the historical peak recorded in the autumn of 1976. The yield curve showed the falling trend typical of periods of credit restraint. The reduction in liquidity as a result of the partly intentional deferment of Treasury expenditure compelled the banking system to have large-scale recourse to the lender of last resort and helped to ensure that the increase in official interest rates spread rapidly to the banks' lending rates.

During the same period new techniques for market intervention were introduced and the markets' operating procedures were modified. The introduction of contracts for the spot sale and forward repurchase of securities has provided the central bank with a flexible instrument that enables it to regulate liquidity more rapidly and with greater accuracy. The establishment of a system for the collective deposit of securities in the two main financial centres and the connection of computer terminals at the Banca d'Italia to a network for the transmission of financial information to market participants have simplified trading and extended the intermediaries' scope for action.

The final outturn for 1979 shows that the flow of total domestic credit was in line with the forecasts made in March. The reduction in budget expenditure and the higher receipts from taxation and social security contributions, which were partly attributable to the more rapid rate of price increase, were only partly offset by the increase in the bank balances of public sector agencies, which had been expected to decline; consequently, the public sector's borrowing requirement to be financed domestically fell by about 3,000 billion lire. Direct financing granted to the private sector increased by the same amount. After adjustment for public sector transfers to businesses, the proportion of total domestic credit flowing to the private sector was slightly smaller than had been predicted in March. On the other hand, the predominant public sector involvement in the credit circuits as a result of the Treasury's growing role as an intermediary does not have a beneficial effect on the allocation of resources.

One indication of the restraint imposed by monetary policy can be seen in the ratio between total domestic credit expansion and gross domestic product, which declined from 22.2 per cent in 1978 to 19.8 per cent last year. In addition, the average ratio between bank liquidity and bank deposits fell from 1.9 per cent in 1978 to 1.5 per cent.

The tendency towards a narrowing of the specific credit function of

the banking intermediaries has been checked. On the other hand, the fact that the lending ceiling was exceeded in the latter part of 1979 aroused fears that the restrictive effect of monetary policy would be weakened.

It was considered advisable to continue to seek the necessary stabilization by use of the ceiling rather than by placing exclusive reliance on indirect control exercised through interest rates. Experience both in Italy and abroad has shown that in the short term the demand for credit may have a low interest rate elasticity. If the desired results were to be achieved interest rates would presumably have had to move to an extent that would have jeopardized the stability of the financial markets, particularly as in Italy they do not yet have the breadth, depth and flexibility of markets in the large industrial economies. Even in the United States, where the financial markets are among the largest and most efficient in the world, the measures introduced by the Federal Reserve in order to keep the growth of the monetary aggregates within the limits included the imposition of direct controls on certain sectors of the credit market in addition to the restrictions exerted through the monetary base and interest rates.

One admittedly minor and partial indication of the difficulties that could have arisen came at the beginning of 1980 as a result of the increase in the discount rate in December. The switching of funds from bank deposits to securities by the public reached major proportions; at the Treasury bill tender in January demand exceeded the amount of maturing bills by 3,000 billion lire, provoking a fall in yields and accentuating the increase in interbank rates. This abnormal situation persisted until the next tender, partly because only a few banks were prepared to sell customers securities from their own portfolios. Not even a market as broad as the Treasury bill market can cope sufficiently quickly with such large shifts in demand.

The conviction that it was essential to increase the effectiveness of the ceiling did not reduce the awareness of the dissatisfaction with a mechanism that forced a uniform rate of growth on the loan portfolio of every bank. It was these considerations and requirements, which are partly conflicting, that induced the monetary authorities in March of this year to require banks that exceed the ceiling to deposit a sum in relation to their excess lending in a non-interest-bearing account at the Banca d'Italia. The intention was to confirm the Bank's determination to keep credit expansion under direct control and at the same time to create an incentive for the banks not to stray from the growth path indicated by the ceiling; however, the ceiling has ceased to be an absolute limit, so that by means

of the progressive rates it can be applied in such a way that sudden peaks in demand may be absorbed, albeit at rapidly increasing costs.

The lending and borrowing activities of the special credit institutions slowed down further in 1979. Loans remained at their 1978 level but declined in proportion to investment. Net of repayments and instalments in arrears, lending expanded by 10.5 per cent, or by three percentage points less than in the previous year. There is cause for concern at the increase in the volume of overdue instalments and bad debts, which reflects the crisis in certain sectors of industry and large industrial conglomerates. A number of institutions have considerably increased their capital. Difficulties in fund-raising have emerged in the past few months, but during the year as a whole this was not the cause of the slowdown in lending; the financial markets have inevitably been adversely affected by inflationary pressures and the squeeze on liquidity. As international experience has shown, the volume of fixed rate securities issued diminishes sharply in such circumstances, with the partial exception of markets on which it is normally possible for securities to be redeemed in advance of maturity.

The desirability of curbing double intermediation was one of the factors that led the Banca d'Italia to propose that the security investment requirement should be extended for the first half of 1980 only at the modest rate that has applied since the second half of 1978. Although we advocate the orderly attainment of equilibrium rates on the market, we have begun to encourage the special credit institutions and ENEL to issue variable rate debt instruments, which have been current on international markets for some time now. On the one hand these offer investors coupons that adjust to prevailing market conditions, thus shielding them from sharp fluctuations in market quotations, and on the other they reduce the risk that the debt-servicing burden borne by the ultimate debtors will prove excessive.

A variety of technical formulae and arrangements have been devised or are under consideration. The linking of yields to prices can usefully satisfy the demands of specific sectors; we are, however, firmly opposed to the generalization of such an approach on the grounds that it could be regarded as a capitulation to inflation and could further reduce the room for manoeuvre in the conduct of economic policy. As far as financial indexation is concerned, the fact that the money market is not yet sufficiently developed to be able to guarantee undistorted rates argues for partial reference to the yields on long-term securities. We do not favour the use of debt instruments pegged to foreign currencies. This is not the case, however, with solutions of the type adopted by international

institutions whereby both current yields and capital value are linked to the ECU, as the EMS is based on this basket-type unit, one of the components of which is the lira.

The acceleration in prices, the deterioration in the external accounts in the early months of 1980 and the expected development of these variables in the remainder of the year confirm the need to curb the supply of credit. The quarterly report on the public sector borrowing requirement that the Minister of the Treasury presented to Parliament in April foresees that during the current year total domestic credit will expand by 59,300 billion lire, an amount that is consistent with a domestic public sector borrowing requirement of 40,500 billion lire. As a percentage of gross domestic product, credit expansion will slow down by approximately two percentage points for the second year in succession.

While taking account of any significant changes that might occur in the real variables and in external factors, the central bank will hold to its present course, continuing to oppose developments that jeopardize the achievement of a slower rate of inflation and exchange rate stability. The stronger the pressures that magnify the spurious component of income, the greater will be the degree of restraint and the adverse effects on economic activity.

Financial intermediation, business finance and the State

In the modern economy, in which there is a growing dichotomy between investment and saving, two separate acts of choice combine to implement an investment project: one, of a productive nature, to make the outlay; the other, of a financial nature, to provide the necessary means. The independence of these two choices ensures the efficient use of resources, while their dialectic contraposition results in a single final decision.

Between the purely market-oriented investments of public and private corporations and collective investment in the strict sense of the term lies the whole range of projects that constitute the essence of the Italian mixed economy, such as those whose purpose is to ensure that production of basic materials will meet future needs, to support technological research in strategic sectors and to promote the development of the less prosperous areas. Which is not to say that such projects should be exempt from evaluation in economic terms. But they belong to the sphere of collective objectives and over time have led to the creation of the various instruments of State intervention.

Here too, just as in the case of investment subject solely to market criteria, the decision of the financial intermediary must be based on an examination of the financial soundness of the project. The decision will in no way invalidate the project in itself but, if the results of its examination call for it, the lending institution must attach conditions, and above all financial conditions, to its involvement.

The examination will be effective if the financial intermediaries are free to act autonomously: it is a matter of interest to the whole community that the law, administrative procedures and institutional and market structures secure this independence.

Three aspects of the Italian financial system have taken on special importance with the passage of time: the institutional separation of ordinary and special credit-granting functions, the use of the financial intermediaries as channels for government incentives and aid to business, and the co-existence of private and public banks. Among others, these problems lie at the centre of an active debate which the Banca d'Italia is following with close interest.

The different economic implications of current business expenditure and outlays for setting up new factories or modernizing or expanding existing ones are the basis of the distinction, which is one of degree and not of nature, between ordinary and special credit. The deferred return on capital, the greater risk element, the scale and the strategic importance to the company of the investment that is being financed are features of special as opposed to ordinary credit. Furthermore, in the case of special credit, the link between the outcome of individual investment projects and the credit institution's own operating results is closer, so that an analysis and evaluation of their economic prospects and even of their technical basis is of major importance. In order to make a meaningful examination of a project in the context of a company's overall activities, the credit institution must assess the balance between expenditure and revenue, scrutinizing financial plans that take into account any grants or other aid that will be received because the particular project is held to be of public utility.

A loan is essentially different from an incentive, whether this be a straight subsidy or some form of relief, and if the difference is ignored it can be detrimental to the effective management of the economy. Credit employs savers' money and involves the acceptance of risk and an obligation to repay; incentives employ taxpayers' money and do not involve the acceptance of risk or any obligation to repay. If incentives are granted automatically for all eligible projects their true economic nature, which is that of an instrument of public finance even when they are linked to interest paid, is quite apparent.

But incentives still retain this nature when they are granted for only some of the projects that would be eligible. The discretionary assessment of those projects that most deserve to receive incentives must necessarily be made on the basis of the criteria established by the law, typical of which is the observance of clearly defined procedures. This assessment is not to be confused with the entrepreneurial evaluation and subsequent decision as to whether credit should be granted or refused, the key element in which is appraisal of risk. Linking the administration of incentives to that of credit implies an intermingling of functions which must be clearly recognized, and its compass, or at least its potential negative consequences, must be kept to a minimum.

Incentives should be attached not so much to the credit element as directly to the investment itself and to the employment of labour. In this way a direct and exclusive relationship is established between the State and the beneficiary firm. More specifically, for the kind of company, especially those of small and medium size, whose investment projects might well be put at risk by procedural delays, greater use could be made of tax credits, thereby ridding the customer/banker relationship of the implications of a subsidy which leads to the growth of special forms of borrowing.

Should it be found that the subsidized loan cannot be dispensed with entirely, there are many ways of improving the working of the present system, as the progress made with recent legislation shows. In general it is preferable that the granting of incentives should be automatic rather than discretionary. When it is necessary to choose between eligible projects the selection procedure should introduce an element of competition. Choices based on political considerations should be confined to cases in which this is justified by the special importance of the project. At all events, if the subsidized credit system is to function more effectively there must be strict separation not only of the agencies that administer the subsidy and the institutions that grant the credit but also of the channels through which these reach the company.

While this' line of approach would increase the efficiency and transparency of efforts to promote new investment, it is equally important in the present situation that everything should be done to restructure existing productive capacity and solve the problems of large companies. The troubles of the chemical sector are particularly acute; its development was an attempt to reconcile the various objectives of improving social conditions, reducing regional imbalance and securing a sounder industrial base. The cataclysmic rise in oil prices and the consequent sharp slowdown in the growth of demand for oil derivatives came at a time when the Italian chemical industry was still fragile. The process of restoring the industry to health has

been less problematic in countries which had embarked on industrialization earlier and had already established a structurally and financially solid basis.

While the crisis of whole sectors of industry was recognized fairly soon, the necessary response has not been so prompt. The law on the restructuring of industry underwent a long gestation period and preparations for its implementation took even longer, partly because the reorganization plans had to be incorporated into overall industrial policy. The position of companies whose problems could have been set right with immediate intervention has meanwhile grown worse, with obvious repercussions for the creditor financial institutions.

These delays have led to pressure to make use of Law No. 787 of 1978 beyond the scope of its original aims, which were to aid firms in primarily financial difficulties and therefore likely to recover with the help of temporary support from the financial institutions. In a number of special cases in which the problems went much deeper and such support had already been considered, additional legislation, and in particular Law No. 573 of 1979, recognized the need for a political evaluation, modifying some of the procedures of Law No. 787 and providing inadequately capitalized public financial institutions with the means with which to intervene.

When a company's survival is considered sufficiently important to override the judgement of the market it is preferable to undertake an industrial rescue operation with clearly defined aims, responsibilities and scope rather than stretch instruments designed for other purposes and founded on the freedom of decision of every financial institution within the limits of its uncommitted capital resources. At all events, whether the rescue operation leaves the company in the private sector or takes it into public ownership the aim must be a return to economic viability.

What has been said holds good irrespective of whether a credit institution is publicly or privately owned. At present the most pressing need is to restore to the banking system the degree of security and certainty without which it cannot function normally and which recent events have even further undermined. For the public banks the risk of operational paralysis is added to the no less serious, albeit less immediate, danger of a decline in the standard of management.

The co-existence of private and public banks is a basic feature of the Italian financial system, in which the business firm has been chosen as the model for banking. A reading of the law shows that, beyond the exigencies which led to their creation, the fundamental purpose of financial intermediaries in which the State holds a capital interest lies in the need to secure a broadly based financial system, to preserve the autonomy of the individual intermediary and to prevent industry acquiring positions of control within

the banking system. Needs that can be linked with the more general one, which is the responsibility of the supervisory authorities, of regulating bank competition in order to keep it healthy.

To transform the public financial intermediaries into institutional tools for the pursuit of particular economic policy goals would be to distort the basic criteria of bank management. It would undermine one of the mechanisms for the allocation of resources, namely a system of financial intermediation in which lending decisions are based on the principle of profitability. This fundamental principle must still hold, even when, in the case of the public and some private banks, its sphere of application is curtailed in view of the special objectives that the law and their own charters attach to their legal capacity.

Accordingly, the supervisory authorities assess the operating results of the individual financial intermediaries, whether public or private, on the basis of identical criteria and essentially similar parameters of profitability, efficiency and solvency. However, some of the market tests of management, ranging from the judgement of shareholders to that of the stock exchange to take-over bids, do not function in the case of publicly controlled institutions, least of all in the case of those that are not in the form of joint-stock companies. But this disparity can be rectified in their statutes, through full use of the internal controls that can be incorporated in public law bodies and through structural changes to promote an entrepreneurial approach to banking on the part of the boards responsible for determining, monitoring and assessing the results of the institution's operations. One way of achieving this last objective would be to establish closer links, though still maintaining the separation of functions, between the banks and the special credit institutions which would, in particular, gain from a more regular flow of information about firms' situations and prospects. Professional banking expertise must also be furthered through the procedures for appointments to the governing boards of the credit institutions. The responsibility that has in some cases been placed with the Governor in this connection is viewed as a duty that will be performed, in the tradition of the Banca d'Italia, on the basis of technical criteria.

The difficulties for the credit-granting institutions of translating into business practice technical rules that only experience can indicate how best to apply are equal to those of ascertaining whether there has been an intention to circumvent them. Therefore, when determining whether both public and private banking intermediaries have properly conducted the business permitted by their statutes, account must be taken of their operating requirements. Similarly, when determining whether they have acted within the law, the same criterion must be used in the case of both

public and private financial institutions in order to uphold not only the fundamental purpose of State involvement in the financial sector but also the truly entrepreneurial nature of banking. It is felt that this approach, which the Banca d'Italia constantly follows, must be given full legal enforcement to prevent a difference emerging between entrepreneurs who are subject to the same economic rules, a difference that may lead to inefficiency.

The continuing day-to-day duties of banking supervision must be performed in an institutional framework that has become uncertain while the principles to be obeyed remain unchanged. The difficult circumstances in which the supervisory authorities have had to operate recently have caused no break in the consistency of their overall approach or of their decisions. During the past year they have been even more active in all sectors; the methods employed and the results obtained are described in the body of the Report.

Special attention has been paid to the question of the role of the Italian financial system in the overall growth of international banking. In the context of the arrangements for surveillance of the international financial markets agreed among the central banks the position of the Banca d'Italia is not to encourage Italian banks to expand abroad through affiliates as long as the information necessary for effective supervision and, in particular, for a reliable consolidation of accounts is lacking. The banks concerned have agreed to provide that information. However, problems remain, principally in connection with the limitations imposed by international law and individual countries' domestic legislation. It is the Bank's intention to secure as quickly as possible the necessary transparency in a particularly delicate sector of banking intermediation.

The basic function of the supervisory authorities is to regulate the financial system so that it is better attuned to the various requirements of the country's economic development. The purpose of their control and their promptings is to reconcile the market's spontaneous entrepreneurial responses with the need for stability and efficiency in the allocation of resources. The achievement of these objectives accords with the task of protecting savings and controlling credit which is embodied in the law, and with the other task, implicit in the law but explicit in the theory and practice of banking supervision, of preventing uncontrolled competition from leading to positions of dominance, for example through economies of scale.

In order to perform this function discretionary decisions must be made within the supervisory authorities' institutional competence. These can be

based increasingly on parameters refined by methods of analysis and forms of intervention that can be improved through joint discussion and research with the financial institutions; they cannot, however, be divorced from a technical assessment of an institution's overall operating results without undermining the collaboration and flexibility that are essential for the proper performance of the supervisory function.

Ladies and Gentlemen,

Addressing the Ordinary General Meeting of Shareholders towards the end of the 'fifties, Donato Menichella clearly foresaw the need for a determined programme of public investment, from infrastructure to scientific research, to revitalize industrial development and the entire economic life of the country, dismissing the doubts of those who feared that the financial means would be lacking and insisting that "it lies in our own power".

In the intervening twenty years of peace and international economic co-operation the country has made great strides, even if it has not always managed to make the best use of the resources available to it. The manufacturing industry of a largely agricultural economy, though still weak and protected, has responded to the European challenge by carving out a share of world markets and securing for its work-force, which has grown by a third, an average per capita income that has tripled in real terms. The generation that joined the labour force at the end of the 'fifties, without having experienced the war, has had more than any previous one not only in terms of living standards but also as regards working conditions, health care, pension provisions and education opportunities for its children.

And yet, despite these great strides forward, there is today a pervading feeling of apprehension. The new increase in oil prices has occurred in a complex and dangerous political context. The inequalities between nations are becoming more glaring, but the industrial societies seem to be blind to the fact, while there is no lessening of social conflicts within their own communities. Because of its greater dependence on imported energy sources and its processing function, Italy is more vulnerable than other countries to the dangers of a crisis in international trade and financial relations. And it faces these dangers without the necessary solid core in terms of productive base, administrative efficiency and infrastructure.

Just over a year ago Italy decided to join the European Monetary System. It was a courageous decision which responded to sentiments rooted in the tradition of the Risorgimento. But it was a decision that

always implied consistent action, at the risk of degenerating into an empty ambition.

This consistency has hitherto been lacking. External events have doubtless made it more difficult but they cannot bear the whole blame. The Italian economy is in danger of sliding back down the slope it so laboriously climbed in 1977 and 1978. The cancer of inflation that has been sapping its strength for years is now attacking with renewed violence. Italian products are losing competitiveness. The public sector deficit is draining available resources. The balance of payments has again moved into deficit. Serious crises in the business sector are dragging on and worsening, and new ones appear imminent.

Monetary measures such as those taken in recent months can slow down the backward slide and mitigate some of its consequences but they cannot on their own reverse it, since the underlying ills are of an essentially "real" nature.

The crisis of both private and public companies, which are accumulating loss upon loss, cannot be resolved with financial aid alone. Such aid can be beneficial, but only once the underlying problems relating to production and sales have been tackled and are being corrected. Otherwise subsidy follows subsidy and waste follows waste under the illusion that the problems are being remedied, whereas they are merely being postponed and allowed to deepen, making the real cure more difficult and more costly.

There is still time, albeit limited, for corrective action. Inflation can be tamed; measures are urgently needed to curb the public sector deficit, promote productivity and reduce costs as the first stage of a programme aimed at quelling the recent upsurge of inflation and making a start on cutting out its deeper roots. For its part the Bank will pursue its policy of monetary stringency.

The vitality of which there is evidence in all sectors of activity is the sign that the problems and conflicts in our society, which sometimes seem on the point of overwhelming it, are the maladies of an organism capable of reacting. It is possible, it lies in our own power, to direct that vitality towards goals selected through a process of debate that does not result in paralysis, to transform it into progress and keep it thriving and strong instead of dissipating it in discord or undermining it through debilitating uncertainty. In this way we can restore monetary stability, which is essential to the welfare of all and is the constant concern of the Bank.