BANCA D'ITALIA

ABRIDGED VERSION OF THE

REPORT

FOR THE YEAR

1980

PRESENTED BY THE GOVERNOR TO THE

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 30 MAY, 1981

THE GOVERNOR'S CONCLUDING REMARKS

ROME
PRINTING OFFICE OF THE BANCA D'ITALIA
1981

III. — THE GOVERNOR'S CONCLUDING REMARKS

To review developments which, although close at hand like those of 1980, have been pushed to the back of our minds by the swift march of events is right and proper, not only in order to fulfill the traditional task of the Banca d'Italia at this annual meeting but also because analytical knowledge of our condition stimulates and supports the act of will that leads to action.

I wish first to stress that we continue to pursue the objective of functionality within the Bank through innovations in internal organization, the provision of a staff that comprises many new members and is well qualified as a result of training programmes and through an awareness of the essential link between the institution and the public interest to be served.

The interaction between central bank and banking supervisory activities on the one hand and economic and legal research on the other has intensified. As it increasingly becomes a part of everyday operations, research usefully disseminates its demands for rigorous analytical method and thoroughness and is, in turn, greatly stimulated.

In the present financial year the Bank's accounting system was improved and the overhaul of operating procedures was continued, particularly with regard to the provincial departments of the Banca d'Italia acting for the Treasury and in relation to the money and capital markets; the project to equip the Bank with new and more sophisticated data-processing systems is in the course of implementation; an advanced stage has been reached in the study of other innovations in the cashiers' departments and in the devolution of tasks to the branches.

Improvements have been sought in staff organization. Partly as a result of the agreements concluded last year with the representatives of the trade unions, a complete framework for negotiations and the exchange of information has been laid down and changes have been made in the career structure to enhance the functional qualification of each individual position and to bring about a closer correlation between grade, responsibilities and remuneration.

The progress made with regard to these administrative aspects suggested amendments to the organization of the departments in the Head Office of the Bank to take account of the growing importance of planning and training methods.

To the staff of the Bank, with whom I share a bond formed in the course of my entire professional career, I wish to address my sincere and affectionate gratitude for their conscientious work, which both expresses and reinforces a style that is a heritage of the Bank and the country, whereby the effectiveness of action to regulate the currency is also enhanced by discretion.

The world economy

In 1980 the world economy first recorded very slight growth and then showed a contraction, albeit a small one. The recessionary impact of the second oil shock was compounded everywhere by the effects of restrictive economic policies.

The rate of growth in the gross domestic product of OECD countries fell from 3.5% in 1979 to 1.3%. The unemployment rate, which was equal to 5.1% of the labour force in the final quarter of 1979, exceeded 6% at the end of last year, when the number of unemployed came to 23 million; there was a further rise in the first few months of 1981.

The leap in the prices of crude oil in 1973-74 had been followed by a sharp increase in nominal wages and a rise in the personal saving ratio. In view of the generally restrictive stance of monetary policy, businesses had reacted to the contraction in profits and consumption by destocking on a substantial scale and reducing their fixed investment. Expansionary fiscal measures had followed, aimed at attenuating the adverse impact that the increase in oil prices had had on production.

Wage demands have been moderate in this second crisis; this response has been accompanied by a decline in the saving ratio, and economic policies have concentrated on containing the secondary repercussions on costs and prices.

A contributory factor in the wage restraint is the realization gaining ground among governments, managements and the unions that the real transfer of resources connected with the increased oil burden has to be accepted and that no demands should be made to offset the rise in prices caused directly by the increase in the cost of energy. In some of the countries in which wage indexation exists incomes policies have partly neutralized its operation.

In spite of the impact of oil prices, the holding-down of domestic costs meant that in the OECD countries as a whole the rate of increase in the consumer price deflator fell to 10.5% in the second half of 1980 after having reached a peak of 12% in the first half of the year. Before the new oil crisis hourly earnings were rising at an annual rate of 9% and the consumer price deflator at 7 %; in the second half of 1980 earnings increased at an annual rate of 11%, the same as that of consumer prices.

The cost in terms of unemployment and inflation was smallest in those countries where the policies designed to slow down the growth in monetary and credit aggregates operated in conjunction with guidelines drawn up jointly by the government, management and unions and with more centralized collective bargaining.

The sustained level of consumption and productive investment, combined with the fact that the stock cycle was rather less pronounced than in the first oil crisis, prevented as sharp a fall in production as in 1974-75 in spite of the smaller cyclical disparities between countries.

In the early months of 1980 the United Kingdom, Canada and the United States were already moving towards recession; in the United States the cyclical downturn came almost a year later than had been widely predicted. In Japan, Italy, France and the Federal Republic of Germany economic expansion continued during the first half of the year. In the six months that followed, the decline affected all the major countries except Japan and Canada. In the early months of this year the world economy has shown a resumption in growth, fuelled mainly by the United States and Japan.

The short-term effect of US economic policy is uncertain, however. The new Administration has drawn up a medium-term programme whereby the reduction in the role of the public sector is to be brought about by encouraging private initiative and saving and curtailing existing forms of regulation. Such action would encourage productive investment and growth, while at the same time reducing the need for government assistance to ailing sectors of the economy. On the monetary front, the deceleration in the aggregates would ensure a progressive decline in inflation.

In the immediate future the burden of stabilization falls predominantly on monetary policy. As the demand for credit is failing to slow down, the Federal Reserve's quantitative targets are leading to high and rising interest rates. This places European countries in a dilemma: they must either accept higher inflation due to exchange rate changes or pursue monetary policies that are more restrictive than would be necessary on purely domestic grounds.

Even if economic policy is formulated with due regard to the need to avoid a renewed fall in production, in the foreseeable future the scope for expanding domestic demand and employment in countries heavily dependent on imported energy will be even narrower than in recent years.

The constraints will be all the more severe in those economies that are slow to encourage the quest for greater efficiency, higher productivity and the expansion and restructuring of productive capacity.

International trade had the effect of transmitting rather than amplifying the cycle in 1980. The fall from 6.5% to 1.5% in the growth of the volume of goods traded was due largely to the decline of about 10% in oil exports, which had, by contrast, increased by 3.5% in 1979. In particular, imports of crude oil by industrialized countries contracted by 14%, with a peak of 20% in the United States.

Declines of between 5% and 8% in the volume of total imports were recorded by the United States, Japan, Canada and the United Kingdom. Moreover, the first two of these countries displayed exceptional export growth, with volume increases of 8% and 18% respectively, owing to the previous depreciation of their currencies. The United Kingdom benefitted from the increased production of oil, although its market share in manufactured goods declined. Mainly as a result of these movements, the current accounts of the United Kingdom and the United States returned to surplus, that of Canada approached equilibrium and the increase in the Japanese deficit was relatively small.

The deterioration in the current accounts of the major industrialized countries was concentrated in the Federal Republic of Germany, France and, especially, Italy, where it amounted to 15 billion dollars. In absolute terms, but not as a proportion of domestic product, the largest deficit was that recorded by the Federal Republic of Germany; it amounted to 16 billion dollars, three times the level of 1979. In France there was a deficit of 7 billion dollars, against a surplus of 1 billion in 1979.

These changes occurred in spite of the fact that the greatest absolute deteriorations in the energy balance were recorded by the United States and Japan; their deficits increased by 15 and 20 billion dollars respectively to stand at about 70 billion in both cases. The increase in the energy deficit was of the order of 10 billion dollars in the Federal Republic of Germany and France and 8 billion dollars in Italy.

The worsening of the German deficit, the attainment of surpluses in the United States and the United Kingdom and the new monetary policy stance in these two countries affected the exchange rates among the principal currencies, the recycling arrangements and the mechanisms for the creation and absorption of international liquidity.

The rise in interest rates had begun in 1979 in the Federal Republic of Germany; last year and this, the rigid control of the monetary aggregates by the Federal Reserve has led to unusually high and extremely volatile nominal rates on financial assets denominated in dollars. Real rates have been correspondingly high; those on DM assets have even exceeded real US rates, notwithstanding the steady worsening in the economic situation.

In effecting short-term international movements of capital, businessmen focus their attention on interest rate differentials and their variations, but also take account of exchange rate developments expected in the period for which the funds are to be held. In 1980 a depreciation of the dollar against the mark was scarcely plausible, given the prevailing and foreseeable relative current account positions of the United States and the Federal Republic of Germany. Investors therefore preferred assets denominated in dollars, thus pushing up its external value. The favourable reception accorded to the new President's economic programme accentuated the rise in the currency's exchange rate.

At least part of the depreciation of the mark against the US dollar — and, indeed, against the Canadian dollar, the pound sterling and the yen — may have appeared to the German authorities as the price to be paid for regaining a competitive edge; between the beginning of 1980 and today the change in relation to these four currencies has been between 25 % and 30%, a movement that cannot fail to have a significant effect on the pattern of current account balances.

In February of this year the need to combat imported inflation led the German monetary authorities to give the defence of the external value of the mark priority over maintaining the level of economic activity. A tightening of central bank credit caused substantial increases in interest rates and the dollar/mark exchange rate stabilized temporarily. The increase in German rates was followed by similar movements in all the major industrialized countries except Japan. In spite of the slowdown in inflation, which is now running at about 10% in terms of consumer prices, US interest rates have recently risen further, with prime rate touching 20.5 %. This has induced a further strengthening of the dollar and an accentuation of the restrictive stance adopted in the other countries.

Interest rate escalation is bound to delay recovery and to sap its strength; hence from this point of view, too, a high price attaches to the current predominant reliance on monetary policy as a means of curbing inflation.

In spite of the size of the OPEC surplus, which rose from 65 to 120 billion dollars, no serious strains developed in the recycling mechanism, partly owing to the distribution of the deficits among the industrialized countries. In particular, the obtaining of direct finance from OPEC countries to the value of more than 10 billion dollars by the Federal Republic of Germany, Japan and, to a smaller extent, Switzerland relieved the pressure on international markets and, at the same time, confirmed the trend towards a multi-currency reserve system, including composite units such as the SDR and the ECU. This new structure is not necessarily unstable, but the problems are greater and call for closer co-ordination of monetary policies in the major countries.

The net financing of balance-of-payments disequilibria by official agencies rose from 13 billion dollars in 1979 to 20 billion last year, mainly as a result of the action taken by the International Monetary Fund to assist less developed countries. On the other hand, the total net flow of credit intermediated by the markets remained almost unchanged at around 150 billion dollars.

The less developed countries also continued to increase their net indebtedness towards the market. However, they had to resort increasingly to direct borrowing from individual credit institutions rather than from syndicates of banks and to pay wider spreads and higher commissions; some accepted a contraction in their gross reserves deposited in the euro-markets. These are clear signs of strain pointing to the need for better surveillance of international banking operations in order to prevent an over-concentration of risks.

The problems seem considerable, particularly when viewed in perspective — those due to the increase in the price of oil and the stagnation of international trade are augmented by those deriving from the strength of the dollar and high interest rates. Between 1979 and 1980 the twelve largest developing countries saw their total oil bill rise from 14 to 39 billion dollars and their interest burden from 7 to 18 billion. In certain large economies interest payments on external debt have risen to between 20% and 35 % of their export earnings.

It is necessary to prevent the financial burden from becoming intolerable. The initial responsibility lies with the less prosperous countries themselves to do all in their power to promote internal adjustment, partly by ensuring more favourable conditions for the inflow of direct investment. The OPEC countries will have to play a fundamental role and, indeed, they are substantially increasing their aid and credits to countries with lower incomes. Nor may the industrialized countries shirk this same responsibility, even in times of deficit; in particular, they must, either directly or through multilateral institutions, maintain an adequate volume of aid designed to bring about a strengthening of the LDCs' economic structures.

The international organizations have already taken steps towards the provision of more effective, longer-lasting support that pays closer heed to the development of supply capabilities, particularly in the energy field, while confirming their commitment to maintain their primary purpose, which in the case of the IMF is to monitor the economic policies and external disequilibria of all member countries and the channels whereby international liquidity is created.

Although the possibility of IMF recourse to the market should not be precluded, it is advisable that it be held at a level that would not distort the structure of its fund-raising based on quotas. It would be preferable to follow the path of direct financing of the Fund by member countries; the recent agreements with the Saudi Arabian monetary authorities and with a group of central banks from the industrial countries represent a significant step in the right direction.

In the second year of the existence of the EMS the currencies linked by the intervention mechanism showed a high degree of cohesion, aided by the underlying weakness of the mark against the dollar. However, the effect of convergence on the performance of prices was outweighed by the different inflation propensities in the various countries, so that the shifts in competitiveness were substantial. These movements were accentuated by the differing importance of non-member currencies in the external trade of the individual countries.

The pound sterling, which belongs to the EMS but is not bound by the exchange rate agreement, was buoyed up by the interest rate differential and the current account surplus, so that it appreciated by 30% in relation to the other Community currencies between the end of 1979 and January 1981; it subsequently declined when the differential was reversed, but it remained 27% higher than at the end of 1979. Inflation moderated, but as it remained above the average for the other industrialized countries, the United Kingdom's loss of competitiveness was greater than the effective appreciation of the pound.

Among the currencies bound by the exchange rate agreement the lira showed the largest change in terms of nominal exchange rates, moving in the opposite direction to the pound sterling.

The decision of the Deutsche Bundesbank to intensify its restrictive stance caused the mark to strengthen from 20 February onwards; it returned to the upper edge of the band and forced the lira below its lower divergence threshold. The lira, whose bilateral margins in relation to the mark and the French franc diminished to about 1.5 %, became vulnerable to speculative attacks. As the trend of the underlying variables made it unlikely that the lira would rise above the divergence threshold, the necessary room for manoeuvre was regained by reducing the currency's central exchange rates within the EMS by 6%. The depreciation of the lira on the market after the parity change has been small in relation to the currencies linked by the exchange rate agreements; yesterday it amounted to less than 2%.

All the other currencies in the system showed small bilateral fluctuations and improvements in their competitiveness, albeit to varying degrees. Until the spring of this year the French franc was constantly in the upper half of the band of fluctuation, whereas the Belgian franc was permanently in the lower half; the two currencies frequently reached their bilateral limits, giving rise to intervention on a substantial scale. The movements of the deutschemark reflected inversely the phases of strength of the dollar; considerable support purchases were made, partly with dollars and partly with Community currencies. As a result of the elections in France the franc has come under strong pressure in recent weeks, a development that has led to the introduction of severe foreign exchange and monetary restrictions; in particular, short-term interest rates have risen to 22%. Although the mark has been weak in relation to the dollar, it remains the only currency in the exchange rate mechanism to be consistently divergent in an upward direction.

All in all, the combination of external pressures and internal difficulties in the first five months of this year have caused serious tensions within the EMS.

Apart from the need for closer co-ordination of economic policies among member countries and more effective support from both the budget and other Community financial instruments, the role and scale of which should be expanded, the system's cohesion suffers from the lack of both a common policy towards the dollar and agreement with the US monetary authorities on suitable action. Moreover, in accordance with the new direction of economic policy, the latter have recently expressed the desire to abstain from intervention in the foreign exchange market save in exceptional circumstances.

The Resolution of the European Council establishing the EMS spoke of the need to consolidate the initial arrangements on a precise institutional basis through the creation of a European Monetary Fund capable of sustaining the process of monetary stabilization; this was subsequently reaffirmed by the Heads of State and Government.

It may prove difficult to maintain and strengthen the EMS without setting up a Fund able to utilize ECUs as a reserve asset and means of settlement, establish them in less precarious forms and provide for their creation in accordance with actual liquidity needs. This entails a qualitative leap that can be achieved only if it is supported by an act of firm political will, directed not only and not primarily towards solving institutional problems but above all to inducing behaviour consistent with the commitments undertaken at the inauguration of the system. A primary requirement will be a greater determination to control the autonomous stimuli to inflation on the part of countries such as our own that are furthest from stability.

The domestic economy

The moderate expansion of the Italian economy following the recession of 1977 developed, between June 1979 and April 1980, into a growth in domestic demand without precedent in the last twenty years. The subsequent downturn led to a brief period in which production declined but remained higher than before the expansionary phase.

Inflation also soared in the six months preceding the peak of the cycle; the deterioration was due to the concurrence of a dramatic rise in costs, in particular those of energy, demand pressures and an intensification of supply bottlenecks in some sectors. A slowdown in the middle quarters of 1980 was followed by a renewed acceleration to an annual rate in excess of 20%.

The cyclical turnround in Italy came a few months later than predicted, lagging behind developments in the other major industrialized economies, while the strength of domestic demand was much greater. Within a short space of time a large balance-of-payments surplus on current account gave way to an even larger deficit.

The recovery from the recession had been stimulated during 1978 first by exports and then by private consumption. The latter continued to grow in the first half of 1979, being sustained by the increase in disposable income, which it later surpassed in terms of the rate of growth. In the second half of 1979 the vigorous expansion in exports and consumption triggered off a strong recovery in investment, particularly in machinery and equipment. In the first quarter of 1980 the capacity utilization rate in industry indicated that a state of excessive demand was becoming widespread. For nine months from the beginning of the acceleration in the upswing, gross domestic product had been rising at an annual rate of 10%. Domestic demand was still at a record level in the second quarter; the increase in relation to a year earlier came to 10% overall, private consumption rising by 6% and investment in machinery and equipment by 26%.

The reversal of the cycle was heralded by a decline in the volume of exports in the first quarter. Owing to the time lags between changes in relative prices and their impact on trade flows, the effect of the uninterrupted loss of competitiveness from mid-1979 onwards was particularly strong during the expansionary phase and carried over until the summer. The reduced ability to compete in foreign markets was reflected in a decline in Italy's share of world trade in manufactured goods, which was itself contracting from the spring onwards. The initial recessionary influence stemming from the external sector was reinforced by the decline in the rate of growth of consumption caused by fiscal drag and by the deterioration in the terms of trade. Fixed investment remained relatively strong until the third quarter, when it fell by 3 %. The build-up in stocks of finished products came to an end in the summer. The fall in production in that period, when firms took the opportunity to extend the holiday closure, may signal a greater readiness on the part of businesses to adjust their production plans to the decline in demand; the reduced availability of credit and its rising real cost provided further incentive to do .so.

In the months around mid-year inflation and the external deficit moderated slightly but remained high, in spite of the easing of the pressure on productive capacity and the pause in the rise in the world prices of primary products. The aim of improving the composition of demand and encouraging a trend towards stabilization prompted the measures introduced on 3 July, which increased taxation on consumption, reduced firms' social security contributions and granted tax exemption for the interest on new bond issues. These proposals had to be resubmitted with certain modifications in August; they expired at the end of September but were re-introduced and passed into law in the three months that followed.

In June and August the Banca d'I talia parried attacks on the external value of the lira. Restrictive monetary and foreign exchange measures introduced at the end of September prevented destabilizing expectations from being encouraged by the current account deficit and a government crisis that had arisen precisely over the management of the economy.

Inflation began to accelerate once again. In the final quarter of 1980 the economy thus demonstrated clearly that the cyclical change had been followed by a sharp break: the transition to a phase of stagnation combined with more virulent inflation.

The appreciation of the dollar from the autumn onwards was one of the factors preventing the desired behaviour in prices. Above all, the further expansion in public expenditure and in the public sector deficit not only had a direct impact but also gave an impression of laxity that aroused the expectation of further price rises and leapfrogging wage increases. In addition, the immediate inflationary impact of measures capable of preventing growth in the public sector deficit and the expansion of loss-making areas — such as increases in utility charges, fares, regulated prices and indirect taxes — was concentrated in those months.

So ended a two-year period in which the gross domestic product and private consumption grew by just under 10% in real terms, investment in machinery and equipment by 30% and domestic demand by 13%; these rates are twice or three times as high as those recorded in the OECD area. The Italian economy surpassed the other countries inasfar as the rate of growth of income and even employment is concerned, but paid the price in terms of external disequilibrium and inflation.

The 175 % increase in the import price of oil between November 1978 and December 1980 did not reduce the peak of the cycle but had serious consequences for inflation and the external accounts. The immediate impact and indirect effects of the increase in the cost of oil were responsible for about one third of the increase in the industrial value added deflator and around one quarter of that in the private consumption deflator, which averaged 18% and 20% respectively in 1980.

The deterioration in the current account balance of payments that began in the third quarter of 1979 amounted to 5% of GDP over the two years; almost two thirds of this can be ascribed to the increase in the oil-related deficit, which was itself due entirely to price, as the volume imported declined. In addition to the higher price of oil, and more generally the unfavourable trend in the terms of trade, there was a fall of 5% in the volume of exports and an increase of 7 % in that of imports in 1980. These changes were caused mainly by the strength of domestic demand in relation to both demand from abroad and available productive capacity and by the decline in competitiveness, which amounted to 2% in 1979 and 4% in 1980.

In the absence of significant improvements in price competitiveness, an easing of the external disequilibrium had been prevented even before the end of last year by the relatively high level of domestic demand, the recessionary trend in the world economy, the appreciation of the dollar and the further worsening of the terms of trade. Credit demand had begun to increase again and had been met, though at increasing cost, thanks to the flexibility of the ceiling and the use of exempted forms of lending, particularly loans in foreign currency. In view of these developments, the Banca d'Italia announced the renewal of the ceiling in advance and on more restrictive terms at the end of January 1981.

In the first few months of the year the situation showed no sign of improvement. The spiral fuelled during 1980 by pricing policies geared in many cases towards short-term profit, by indexing mechanisms that transmit and amplify inflationary pressures and by rising public sector expenditure threatened to spin out of control in a welter of sectoral demands for higher wages and speculation on the foreign exchange, securities and commodity markets. The lira sank to its divergence threshold within the EMS.

These circumstances, which are adverse in the present situation and disquieting for the future, caused the authorities to adopt a package of stabilization measures that would operate in three areas — public sector current expenditure, the growth of money incomes and the supply of credit.

This led to the decisions of 22 March. The Government undertook to reduce the deficit, adjourned the wage negotiations with public employees and called for wage restraint in the private sector. The discount rate was raised from 16.5% to 19% and the marginal reserve requirement from 15.75% to 20%. The parity of the lira in the EMS was adjusted in order to protect the currency from speculation, bringing the rate back to the centre of the band of fluctuation.

There was a delay in implementing the declared intentions, thus using up the room for manoeuvre gained as a result of the emergency measures, which had implied that broader and more decisive economic action would swiftly follow. It was not until the new government crisis arose that measures to reduce the deficit were approved by means of a decree law. The authorities had to introduce a further emergency measure in the form of a non-interest-bearing deposit of 30%, frozen for 90 days, on foreign payments.

The necessary adjustment of the trade balance, which showed a deficit of 19,000 billion lire in 1980 and has to bear an added burden of about 4 billion dollars this year solely on account of the increases in oil prices that have already occurred, has not yet got under way. Total imports have declined in volume, but the small improvement is outweighed by the appreciation of the dollar, and it is proving difficult to expand exports in view of the worldwide weakness of demand. In the first quarter of this year the trade deficit came to about 5,000 billion lire, compared with 3,800 billion in the same period of 1980. In the first four months the current account on a settlements basis recorded a deficit equal to more than half that for the entire preceding year.

These figures are a stark indication of the size of the change in the relationship between domestic and foreign demand required to set in motion a process of adjustment through the net exportation of resources to offset the past and continuing deterioration in the terms of trade.

The level of domestic demand continues to be influenced by the Treasury borrowing requirement, which has amounted to about 4,000 billion lire for several months running, thus frustrating the effects and expectations associated with monetary management and obliging the continuous use of the latter to mop up excess liquidity. Economic surveys among businessmen carried out at the beginning of April indicate a recovery in the inflow of orders and an expectation that production will not decline; at the same time, the demand for bank loans shows no sign of slowing down. Inflation persists at an annual rate of around 20%, sustaining the differential between Italy and other countries. In manufacturing industry the increase in unit production costs is tending to exceed that in final prices.

This disturbing development is partly due to the worsening of external factors; however, this observation should itself arouse awareness of the pressing need for more decisive action with regard to the economic variables that Italy has the power to control.

The speed with which the expansion in demand reached the limit of productive capacity in the early months of 1980, the high levels of activity that continued to prevail subsequently in spite of credit restrictions, the persistence of a high balance-of-payments deficit even after the peak of the cycle had been passed — all this can be better understood if one considers not only the cyclical factors and exogenous domestic and international stimuli but also some of the underlying conditions of our economy.

The growth and modernization of productive capacity had been suffering since 1974 as a result of the stagnation in fixed investment, which slowed down the restructuring necessitated by the large changes in relative prices and in the distribution of income and wealth. In a situation such as this the expansionary phase of the investment cycle was extremely vigorous; the available plant was soon fully utilized, so that the pressure to expand capacity complemented the need to adopt techniques more consistent with the new structure of prices and costs.

Companies were not in a strong financial position to cope with this revival in investment. In the decade from 1969 to 1978 borrowing had increased to almost 60% of total assets and short-term debt had risen from 37% to 44% of the total. The proportion of earnings required for the payment of interest, which had amounted to 3% in 1973, had doubled by 1978, with peaks of 12% in some sectors. Under such conditions capital formation needs could only be met by counteracting the steady deterioration in balance-sheet ratios. The normal and prevalent relationship between profits and investment is a causal link running from the former to the latter; in those firms that were more acutely aware of the urgency of restructuring, this became overlaid by another relationship dictated by the need to widen their profit margins in order to limit the financial risk. Expectations of a depreciation of the lira probably reduced companies' concern about the danger of losing their market shares, on the assumption that they could rapidly offset the decline in competitiveness.

Gross profits in manufacturing industry benefitted from both the expansion in sales and the rate of increase of 19% in producer prices, which just exceeded the increase in overall unit costs. Within the latter, unit labour costs increased by an annual average of 14%, taking into account the further partial relief from social security contributions; costs per person employed in fact rose by 21% and labour productivity by 6%.

The urgent need for investment in the restructuring of industry, which was long overdue, and the higher self-financing required to achieve this reduced firms' sensitivity towards the high cost of credit inflicted by monetary policy.

The intensification of investment coincided with the emergence of a disturbingly high level of consumer spending that was incompatible with overcoming the present difficulties. The prolonged erosion of the domestic purchasing power of the lira accompanied by a highly distorted structure of relative prices for goods and capital assets and by the elimination of lags in the replacement of durable consumer goods was reflected in households' propensity to consume, which rose by 4.5% between 1978 and 1980. The rise in the value of the real assets element of wealth may have more than offset the erosion of the financial component, thus stimulating consumption. Above all, the time required for consumers to take note of developments and to react has shortened in view of the persistence and accentuation of inflation. There is a danger that the high average saving ratio of Italian households will diminish as inflation takes root.

The interweaving of cyclical movements and fundamental deficiencies has become apparent not only in capital accumulation but also in foreign trade in manufactured goods.

The import content of investment goods, which has always been high in Italy, was accentuated by the slower growth in industrial capacity between 1975 and 1978, which primarily affected capital goods. In addition, world demand has been directed towards investment goods rather than consumer goods and, within the latter, towards products other than the so-called mature ones, such as textiles and clothing, the traditional preserve of Italian exporters. In these sectors competition from less developed countries, especially those in the Far East, has grown keener.

Trend figures show that, unlike other industrialized countries, Italy has increased its specialization in mature industries, where price competitiveness is more important. This orientation creates the danger that Italy will slip into the group of second-rate economies, which have little by way of advanced industries and are being hard pressed by the newly industrialized countries, which employ cheap labour that is not protected by extensive social legislation.

The intensity of the phase of capital formation constitutes the most valuable legacy of the expansionary cycle of the last two years and is a precondition for a recovery in competitiveness, the emergence of which is linked to greater flexibility in the use of the factors of production, which will itself be the outcome of improvements in industrial relations and of economic policy measures.

Management of the currency and of the exchange rate

In a situation in which the spontaneous trend of the international cycle and the economic policies pursued in the major countries were both tending to depress trade, domestic demand restraint and the maintenance of a substantial degree of stability in the external value of the lira were the only means of resisting the pressure on prices. The desire to curb inflation, the knowledge that defence of the exchange rate would become more difficult if the deficit in the current account of the balance of payments reached large proportions, the aim of overcoming the cyclical problems in a short space of time in order to concentrate the country's resources on strengthening the productive sector — these should have been the co-ordinates for the formulation of economic policy.

The objective of holding down aggregate demand while safeguarding investment and exports would have required measures to limit the public sector deficit, thereby supplementing the automatic effects of the prevailing rise in nominal incomes, and to slow down the escalation in companies' costs and in households' disposable incomes.

Instead of this, as the rise in tax receipts began to reduce the deficit, increases in expenditure and reductions in revenue were decided that largely neutralized the automatic stabilizing effects. In December 1979 the sliding wage scale for public employees was placed on a quarterly footing; in February 1980 pensions were improved; in April personal income tax allowances and family benefits were increased; it was agreed that arrears and advances in connection with the new contracts for public employees would all be paid in 1980. In the year as a whole expenditure rose by 26% and the overall borrowing requirement of the enlarged public sector remained as large as in 1979 in proportion to gross domestic product.

The fiscal measures decided at the beginning of July went in the right direction, but the events that accompanied them impaired their effectiveness, adversely affecting prices.

The provisions adopted in 1980 began to exert an influence on the budget in the second half of the year, creating a net burden of about 6,000 billion lire; in that period the ratio between the public sector deficit and GDP reached its highest level for five years. At the end of 1980 and in the opening months of 1981 not only was the public employees' contract for the period 1979-81 concluded, but other measures with expansionary consequences were decided or agreed with the trade union organizations, including the adjustment of pensions every four months, new personal income tax allowances and rates and the renewal of agreements with hospital staff. The problems relating to the balance of payments and inflation thus grew more acute, partly as a result of the announcement of these measures.

Monetary policy had already assumed a restrictive stance in the final quarter of 1979 with the 4.5 point increase in the discount rate and the renewal of the credit ceiling, which limited the growth in non-exempt bank lending to an annual rate of 11% in the period up to July 1980.

Interest rates rose, those at the short end of the market increasing at a particularly rapid pace. Bank lending rates rose from 17.5 % to 22% between the beginning of October 1979 and April 1980. An even faster increase would have jeopardized the equilibrium of the financial system and especially that of the business sector, where debt ratios were high and very varied.

The exceeding of the limits on credit expansion in the autumn of 1979 and the first few months of 1980, which reached a peak of 4,000 billion lire in January, facilitated the increase in production and investment but also contributed to the worsening of inflation and the balance-of-payments deficit. The indirect control exercised via the banks' reserves and by raising interest rates was therefore supplemented in March by the tightening of direct controls through the introduction of a non-interest-bearing deposit on amounts in excess of the ceiling.

In the first half of the year the rise in interest rates and the change in their structure was reflected in a shift in public preference towards Treasury bills, for which subscriptions came to 13,300 billion lire, at the expense of deposits and, to a lesser extent, medium-term securities. During that period the banks' total deposits recorded a decline of 2,300 billion lire. Faced with a phenomenon that was familiar but unprecedented in scale and with credit demand strong, the banking system chose to respond not by pushing up deposit rates but by reducing its own holdings of Treasury securities by 7,700 billion lire; in this way it was able to increase exempt lending in lire by much more than had been predicted.

In the months around mid-year pressure on the lira further complicated the task of stabilization by means of monetary policy. At the end of May the lira moved the full breadth of the narrow EMS band of fluctuation. In June came the first assault on the currency; in view of the width of the band of fluctuation, part of the pressure could be absorbed by allowing the exchange rate to slip further by almost 2% against the other Community currencies. The wave of speculation was stemmed by the signal of firmness given to the market by the advance renewal and tightening of the credit ceiling. The flow of short-term capital reversed in July, permitting the replenishment of reserves. In August, however, fresh rumours of devaluation made it necessary for the authorities to give substantial support, which continued on a smaller scale in September.

The day after the government crisis, which jeopardized the effectiveness of the fiscal measures taken in July, the official discount rate was raised by one and half points and exchange control measures were introduced to curb speculative movements of capital.

After the crisis had been overcome the authorities were faced with a conflict between the need to finance the external deficit and the necessity of restricting credit; it was considered that the special emphasis placed on the former had to be reduced, and accordingly in December the foreign exchange controls introduced at the end of September were removed.

Partly as a result of these controls, the banks' external liabilities rose by 4,000 billion lire in the final quarter, permitting the financing of the overall balance-of-payments deficit of 1,900 billion lire and an increase in the reserves. The banking system's net external liabilities rose to 15,000 billion lire, more than double the figure recorded at the end of 1979.

If the figures on financial aggregates and interest rates together are set against the trend of incomes and prices, it is apparent that liquidity conditions in the economy and on the credit markets were tight throughout the year, and particularly in the second and third quarters.

The rate of growth of the monetary base was 13.6%, practically the same as in the preceding year in spite of the pressure exerted by the Treasury borrowing requirement; the increase of a further 3 points in the average interest rate on Treasury bills helped to tilt the public's portfolio preference in favour of short-term securities and reduced the banks' demand for monetary base.

The economy's financial assets as a proportion of gross domestic product fell by an average of 5% in relation to 1979; the liquidity ratio of businesses declined by the same amount; bank lending rates rose by more than 4 points to stand at 23.5 % at the end of the year.

The ratio between total domestic credit expansion and GDP had fallen from 22.2% to 19.6% between 1978 and 1979; in 1980 it decreased further to 18.8%. The reduction was particularly severe until the third quarter — in the twelve months ending in September the ratio fell to 16.2%. In the final quarter credit expanded at almost twice the rate recorded in the preceding nine months owing to the growth in the public sector deficit, which in that period accounted for almost half the increase for the entire year, and to the expansion in foreign currency lending.

Even if a broader concept of financing is used which includes medium-term borrowing abroad, bankers' acceptances and shares, it is still evident that there was a reduction in the ratio until September, though this was almost entirely neutralized by the acceleration in overall lending in the fourth quarter.

In the new year the problems were magnified; in the late autumn of 1980, when the statistics were indicating the progressive worsening of the trade deficit and the renewal of acute pressure on prices, warnings had already been given about the need to tighten the credit restrictions. Bank reserves were regulated by making extensive use of repurchase agreements on securities and the technique of the competitive auction.

At the end of January the renewal of the credit ceiling was announced; the provisions were extended to include loans of less than 130 million lire and at the same time a freeze was imposed on the foreign currency financing of imports. Greater use had been made of the exemptions than had been predicted, facilitating an increase in bank lending to medium and large firms as well; this was mainly achieved through an abnormally large growth in multiple credits, with the risk that individual banks might become less prudent and selective in granting loans.

In the first three months of 1981 the public sector borrowing requirement amounted to 12,000 billion lire and the increase in total domestic credit exceeded 17,000 billion; in the same period of the preceding year the shortfall had come to 4,000 billion lire and total credit expansion only slightly over 7,000 billion. The borrowing requirement has remained high in the last two months.

In order to counteract the expansionary effects on liquidity and to tackle the problems that had arisen on the foreign exchange market, some of which were due to international tensions, it became necessary to increase the discount rate and the reserve requirement coefficient in March and to introduce a non-interest-bearing deposit on foreign payments on 27 May.

Greater control over the creation of monetary base and stricter adherence to the quantitative targets for this variable, particularly with regard to bank reserves, might be obtained if the system of Treasury financing were modified. The Banca d'Italia would cease to take up all Treasury bills not placed in the market at the auctions, acquiring only amounts consistent with monetary policy objectives. The Treasury would thus try to raise the required finance in the market, partly by increasing the frequency of the auctions.

We are aware of the problems raised by the co-existence of direct and indirect methods of control; during the past year we have made adjustments to both in order to preserve the effectiveness of their joint operation in this situation. Direct controls produce their greatest impact when they are introduced or modified; they are then eroded by forms of evasion that are costly for the banks, distorting for the economy and difficult for the authorities to counter.

In the prevailing economic conditions — in particular, the persistence of expectations of high and variable inflation, the inadequacy of policies other than monetary policy and the need to moderate the rise in interest rates — it would be inadvisable, however, to relax direct controls.

The smallness of the increase in bank deposit rates, which was partly due to the ceiling on lending, was a major contributory factor in holding the nominal yield on financial assets well below the rate of inflation; the shift in the composition of wealth towards real assets was impeded to only a small extent by the higher level of interest rates. One positive feature was the resumed flow of savings into the direct financing of companies, particularly in the form of equity capital; on the other hand, consumer spending and the demand for shelter goods increased.

Clearer differentiation between the various categories of deposits in accordance with their stability and term might mitigate the penalization of financial saving and bring about greater transparency in the markets. The banks should be encouraged to amend their policies in order to achieve this objective.

The experience of 1980 confirmed that in times of great market uncertainty about the future development of interest rates it is difficult and sometimes inadvisable to resist the shift towards short-term securities. By offering them, the authorities can cover the public sector deficit while containing the creation of monetary base, even if the degree of liquidity of financial assets remains high. When the repetition of periods of instability strengthens the aversion of savers towards long-term financial instruments, the range of short-term issues widens, increasing the possibility of switching between assets and reducing the significance of the growth in the monetary aggregates as an indicator of overall liquidity.

In such circumstances particular importance attaches to the policies for the non-monetary financing of the public sector borrowing requirement and to the lengthening of the maturity of the debt.

The change in the terms for Treasury credit certificates in 1981, including the payment of a premium over short-term rates, promises to encourage this process and, in addition, to reduce the debt servicing burden when the rise in prices slows down. This is the direction in which we should proceed, especially if we wish to be able to count on a broad and flexible money market; the indexation of interest rates meets the needs of lenders and borrowers alike in the present climate of uncertainty about the time-scale for the easing of inflation, as was shown by the growth in the variable rate bonds issued by the special credit institutions in 1980.

It appears inadvisable for the state to issue traditional fixed-interest securities for periods longer than the medium term. The very high yield that would be necessary to overcome the public's reluctance could undermine expectations of a lasting reduction in inflation. Furthermore, when such a slowdown did occur, the servicing of the debt would prove an excessive burden.

On the other hand, the generalized indexation of public debt in terms of prices might be regarded as a capitulation to the debasement of the currency and a demonstration of the inability to eliminate or attenuate the mechanisms that perpetuate and amplify inflationary pressures in our economy. In the case of indexation of the principal, there would be the added fear that a further immediate easing of the budget constraint might make it even more difficult for the government to resist pressures for still higher expenditure.

In the past we have spoken in favour of financial institutions issuing bonds linked in capital value to the ECU, in accordance with the prospect of monetary convergence in Europe and a strengthening of the lira within the EMS. If the issuer were the state, however, the danger that this would be regarded as an abandonment of the will to stabilize our own currency should not be underestimated. Not even the use of the auction method for issues indexed in this manner could avoid causing disequilibrium in the domestic capital market, unless the right to purchase the securities were restricted to well defined sectors.

The situation would be different if the floating of government securities linked to the ECU were coupled with economic measures agreed with the employers and the unions aimed at eradicating the structural causes of inflation. The link with the ECU could be a symbol of the country's and the government's defiance towards inflation and of the commitment to act entirely in keeping with membership of the EMS.

The question of the rationalization of the various forms of taxation on financial assets also arises in this context. With the erosion of such assets owing to inflation, nominal yields often do not provide any real remuneration but represent an advance repayment of principal. Changes in the system of taxation, which would be valid in a situation of monetary stability, would undermine the confidence of savers, which must, instead, be regained.

Total domestic credit expansion for 1981 has been set at 64,500 billion lire; it should decrease to 16.5% as a proportion of gross domestic product. Credit to the economy, including funds received from the public sector and from abroad, should also decline by 2 percentage points in relation to GDP. These targets are based on the commitment, repeated in recent government publications, to prevent the domestic borrowing requirement of the enlarged public sector from exceeding 37,500 billion lire; in view of the figures for the first five months of the year, this necessitates a large reduction during the remainder of 1981.

The pursuit of these credit objectives is essential if price stability is to be re-established; however, to be successful it must be accompanied by a programme of measures relating to the budget, the allocation of resources and to incomes.

Monetary and credit policies can curb and slow down inflation, but they cannot eradicate it unless far-reaching changes are made in the way our society behaves. If these policies have a decisive effect it will not be in making such changes unnecessary but in hastening their adoption in a society that has become convinced of the need for them.

The complement to such a restrictive monetary policy is action aimed at reducing imported inflation by means of an exchange rate strategy, although the scope for this is limited when the dollar is strong, as at present.

The fact of having resisted the downward pressures on the lira within the EMS in the circumstances in which they arose in 1980 not only contributed directly towards containing inflation but also induced reactions and behaviour within the economy that themselves promoted greater price stability. Once the easy option of devaluation had been rejected, many firms improved the organization of production by agreement between the management and the unions in order to resist cost pressures.

This does not mean that formal parity adjustments within the EMS should be ruled out in all circumstances. They are consistent with the rules and the spirit of the system. That was what occurred on 22 March of this year. It was a necessary act, dictated by reality, but it was the bitter reality of a failure that could have been avoided in an efficient economy and society; room for manoeuvre was regained, but only by taking a retrograde step. The day of the devaluation was a day of realism; it certainly was not an auspicious one.

Aspects of state intervention in the economy

The last decade has seen a further increase in the community's demands upon the public sector. A critical point has been reached in the trend that sprang from the crisis of the thirties and led all countries to give economic and social policies a central and permanent role in the pursuit of growth and prosperity. The intention underlying that trend, which was to strengthen and stabilize the economy's investment potential, has become blurred and the task it prefigured has often degenerated into passive support. In a large number of cases transfer payments to families have become permanent subsidies rather than a temporary substitute for lost income; state grants to companies have redistributed value added rather than directing investment and its location; the growth of employment in the state machine has served to absorb manpower rather than to expand its capacity to provide services.

The speed at which the ratio between public expenditure and national income has risen and the extremely high levels it has reached, in some countries around 50%, testify to the stimulus to which the public sector has been subjected, giving rise to expectations that were bound to prove excessive as demands multiplied.

Awareness of the crucial importance of the reallocation of resources in the current crisis has been slow to develop. It has increased of late, however, as has the conviction that today the main task of economic policy is to accelerate -this process by means that do not further magnify the state's role in the economy. The need for the public to abandon, or to be persuaded by positive measures to abandon, the attitude that every want should be met in the first instance by the state; the necessity of preventing excessive growth in public functions other than those essential for the operation of society; a preference for measures that would indicate solutions to the private sector while maintaining a fair balance between this and the public sphere — these are the guiding principles of action aimed at attacking the roots of the crisis rather than alleviating its consequences.

In Italy public expenditure has increased at an extremely rapid pace and in ways determined by the succession of often uncoordinated and sometimes conflicting measures that have been introduced. The scale of action required to induce essential changes in the productive sector and in the composition of demand necessitates immediate decisions regarding the use of the state's share of resources, which cannot be expanded further. The fact that such action is bound occasionally to take a direct form means that society must exercise restraint in the other demands it makes on the state and requires efforts to increase the operational capability of the government machine and the efficiency of state action.

The pursuit of the latter aim requires on the one hand an organizational reassessment of the general government sector as a supplier of services to the community and, on the other, an increase in the sector's capital endowment. In Italy the share of investment in total public expenditure is lower than in most other countries and insufficient to nurture technical advance within the state machine or to supplement capital formation in other sectors, thereby increasing productivity.

Greater investment would be to no avail, however, if it were not accompanied by a stricter commitment to minimize costs and improve the service provided.

The fundamental criterion from a strictly economic point of view continues to be the need to strengthen competition outside the public sector and to kindle similar stimuli within it. If this is to happen, the budget constraint must once again exert a disciplinary force both as a regulatory instrument and as a standard of ethics. By long tradition it has become the linchpin holding together a heterogeneous society and an economy with a perennial temptation to hide behind subsidies.

Clear priorities in the choices to be made are necessary not only in order to ensure the efficiency of the state in providing essential services but also in view of its ability to direct the allocation of resources in the rest of the economy.

The links between various types of economic activity as well as the particular nature and intensity of the problems involved place the energy sector and the agricultural and food sector at the top of the scale of priorities. It is here, in particular, that supply deficiencies are evident, holding back growth and imposing a burden on the balance of payments. This has come about since the beginning of the seventies; in the course of the last decade the constraints have appeared at levels increasingly below full utilization of the economy's production potential.

Italy cannot continue to bear the balance-of-payments deficits of these two sectors without slipping down the slope of protectionism. The problems of agriculture have obvious social importance, when one considers that it provides a livelihood for about one-tenth of Italy's population; they are also of great economic complexity, ranging from relationships within an enlarged EEC to those with manufacturing industry, from the distribution and marketing of produce to the size of farms and the spread of technical progress. Only a concerted attack on all fronts can open the way to solution of the sector's problems.

In the energy field the measures to be taken are determined by technology and the relative costs of the various energy sources. In spite of the fall in the income elasticity of energy consumption in recent years, the potential for energy conservation remains high. Some savings can still be made at no cost at all; others require substantial investment coupled with a broad restructuring of production and a change in the patterns of consumption. Both types of saving should be encouraged and sustained by specific incentives, appropriate regulations, modifications in relative prices and improved information.

In view of the likely increase in per capita consumption, which is comparatively low, and the need to reduce the country's dependence on imported energy, efforts should not be restricted to energy-saving but should also be directed towards the expansion of domestic supply. The course to follow is indicated by the need for the diversification of energy sources — oil now accounts for two-thirds of total requirements — and by the cost of energy generated in oil-fired power stations, which is one and a half times that of energy produced from coal and more than twice that of nuclear energy.

In other basic industries, including chemicals and steel, a state of international crisis is interwoven with the specific problems afflicting large companies in Italy — problems of management, industrial relations, finance and their role as public or private entities.

In the chemical industry these factors have had a disruptive effect, causing the break-up of some large groups. The reallocation of plant according to specialization presupposes the strict assessment of their potential viability. The new structure would be placed on a sounder footing if the overlapping of public and private in the two leading chemical groups were gradually eliminated. Internal difficulties have made the Italian steel industry, especially the part under state control, more sensitive to the slump in the market in spite of the viability of a good proportion of the plant.

In the case of both industries, financial measures that will absorb vast resources diverted from other uses must be strictly linked to the thorough rationalization of plant and the restoration of operating conditions that make it possible to eliminate inflexibility in the use of the factors of production and to conduct a rigorous test of economic efficiency.

In more general terms, attempts to solve the entire question of ailing companies, which have engaged the efforts of politicians, trade unionists, businessmen and financiers for years, have made little progress so far in relation to the cost involved, partly owing to slowness in casting off the constraints of prejudice, such as the insistence on equating the rescue of a firm with its nationalization.

State intervention to save a firm that the market would allow to go bankrupt can be justified on the grounds of the common good and is even practiced in economies with a strong market orientation. Nationalization is not a necessary corollary of such an operation. It is not the only way of preventing the dispersion of resources that it is considered useful to maintain as a unit and of safeguarding the principle that the incompetent entrepreneur is removed from the firm and that the consequences of the voluntary assumption of risks fall upon the proprietor and creditors, according to the nature of their respective positions. The community's money is intended not for rescuing these parties, but for saving whatever goodwill and plant can be salvaged. State intervention might be limited to restoring the conditions necessary for finding someone prepared to assume a new risk. If no-one can be found, it means that more resolute action is required to revive the firm or that capacity must be reduced.

These thoughts reflect an attitude based on two assumptions — first, that the size of the state's role in Italy's productive sector is without parallel in any Western country and is approaching the point at which the system ceases to be a market economy and, secondly, that the need has grown for collective choices affecting the behaviour of individuals and firms.

Experience in Italy and elsewhere forces us to conclude that, once the essential priorities have been established, intervention is generally more effective if it bears upon the structure of supply indirectly rather than directly. Instead of regimenting business decisions by means of an administrative apparatus of directives and controls, it is preferable to introduce measures to affect the flow of information, institutional structures and the network of constraints and incentives by which decisions are shaped.

Increasing the internal efficiency of the government sector, setting clear priorities for the allocation of resources and improving the means of implementing the latter are the paths to be followed, bearing constantly in mind that Italy is alone among the major industrialized countries in still having an acute development need in a large part of its territory. The development of the South remains the central problem facing Italian society. The earthquake of 23 November raised the question afresh in a dramatic way. The reconstruction and economic development of the affected areas in Campania and Basilicata could initiate a new trend in which state intervention did more than increase transfer payments still further. Resisting the understandable sectoral and municipal pressures, the authorities should calculate the financial requirement with great care, distinguishing clearly between funds for the repair of material damage and those for development. Moreover, reconstruction should be co-ordinated with the policy of attracting industry to the area, as far as the existing infrastructure permits, and should be able to rely on sound entrepreneurial skills, which need to be nurtured.

The extent to which the suggestions and principles recalled here were applied last year was inadequate in relation to the urgency of the problems. The government's three-year plan demonstrates the will to bring about a change. In a macro-economic setting that for methodological reasons disregards the cyclical development of demand, the plan re-affirms the need to improve the composition of the budget with the aim of reducing the size of the deficit on current spending and increasing the proportion of capital expenditure. These are two intermediate objectives to be pursued separately within a predetermined budget constraint that precludes any trade-off between the two. These requirements coincide to a large extent with the need to modify the institutions and decision-making bodies in general government that generate less essential or less productive expenditure. Such a modification presupposes a policy for the allocation of resources that consists in the clear definition of priorities and the direct verification of each programme's ability to achieve the objectives set.

Towards better order in the financial system

Last year there was an intensification in the factors tending to reduce the portion of total new financial assets and liabilities reflected in the balance sheets of ate credit intermediaries, especially those of the banks, and to increase the share transacted directly between savers and final users of funds.

In a financial system with a strong historical bias towards use of the intermediaries rather than the capital markets in the narrow sense, a tendency for the relative size of the latter to increase may help bring about a permanent improvement in the balance, efficiency and stability of the entire credit system. However, the reduction in the portion accounted for by the intermediaries, and especially by the banks, must be gradual to ensure that it benefits their overall assets position, operating results and capital base and, hence, that the process takes place in completely stable conditions.

Last year and in the first few months of 1981 the change was occasionally too rapid, owing in some instances to factors that were accidental and in some respects disquieting. The in some ways improper intermediation carried out by the public sector continued to exert pressure to take over the activity of the credit institutions, often with adverse effects on the allocation of resources. The special credit institutions' growth was hampered by the obstacles that a high and variable rate of inflation places in the way of the issue of medium and long-term securities, by the delicate phase of reorganization and managerial change and by the wait for clarification of the institutions' legal position. Partly as a result of the better opportunities for profits that characterized a year in which the cycle reached its peak and the monetary policy stance was restrictive, the banks' interest rate spread widened for the first time in four years, thus contributing to disintermediation.

The controversy about so-called excessive bank profits was consequently rekindled by arguments of a conflicting nature. Although the Italian banking system is not highly concentrated, competitive conditions differ according to the type of activity and the region of the country, as can be observed in the lack of uniformity in bank charges and rates of profit. Furthermore, the banks' interest rate spread reflects the composition of balance-sheet assets, which is inflexible on account of the administrative requirements that the monetary authorities are constantly obliged to impose;

ways of raising capital other than endowment funds by issuing marketable securities that would entitle the holder to share in the institution's operating profits and risks but not in its management.

The publicly-owned bank should be compelled by its constitution to make internal assessments of the viability of management policies and individual transactions. The overall effectiveness of banking supervision is highly dependent on the continuous and precise execution of such assessments by the bank itself.

It is also essential that powers be correctly apportioned between the governing bodies and managements of banks. The public appointment procedures, insofar as appointees are chosen from among candidates with suitable professional qualifications, are designed to ensure such a division of powers.

Last year the abnormal situation in a large number of savings banks, where the highest positions were vacant or in abeyance, was resolved. In response to a request based on the interpretation of the relevant legislation both in Parliament and elsewhere, I provided the Minister of the Treasury with lists of candidates chosen according to strictly professional criteria, which served as the basis for the Minister's decisions after consultation with the Interministerial Committee for Credit and Savings. In the few cases in which the government decided to appoint other candidates, a completely separate procedure was followed in which the Governor's role consisted, as in the case of pledge banks, in giving a professional opinion that was binding if it was unfavourable. The appointments, which have received parliamentary approval, have eliminated problems that had become extremely complicated and have restored the full powers of the governing bodies.

In a market situation in which the stimuli to extend the range of financing mechanisms are increasing, especially in the international field, the supervisory authorities must encourage the evolution of both private and public intermediaries and safeguard their stability. One aspect of this problem, namely the interests banks may acquire, was the subject of a recent directive of the Credit Committee, which laid down the conditions for possible acquisitions by establishing the principle that investments in equity may be made only if they will promote a better structure in the credit system and increase its efficiency and viability. Under this ruling banks may acquire interests in other credit institutions or in companies providing services linked to banking activities. As a further reinforcement of the limitations to which the sector will be subject, interests acquired in order to recover loans will have to be sold within set time limits.

In view of the more complex and risky conditions on international markets and the need for transparency, the directive also forbids Italian banks to acquire interests in foreign holding companies. As the various establishments of an international bank are required to conduct their business according to different sets of regulations, it was also laid down that authorization to establish affiliates abroad would depend on the ability to obtain the necessary information and on the supervisory arrangements operating in the countries involved.

The most reliable technique for ascertaining the solvency of a company is consolidated accounting; its use presupposes the flow of information between subsidiaries and parent companies in different countries and will be fostered by agreements between supervisory authorities. Pending legislation to introduce the consolidated balance sheet, the banks must henceforth lend their assistance in providing systematic information on their financial links with foreign subsidiaries.

In the special credit sector the task of reorganization was pursued not only by increasing the institutions' capital but also by widening their field of operations and the possibilities for the diversification of risks and by deciding to incorporate the Public Utilities Credit Institute into the Credit Consortium for Public Works, which has also been authorized to grant loans to industry. Above all, the instruments of supervision in this sector have been revised by making all institutions subject to the same requirements with regard to reporting and authorization to establish new branches and to the same provisions relating to administrative sanctions and liquidation.

The discussions that have been held in various circles have provided useful information on the limits for credit subsidies and demonstrated the advisability of making government departments directly responsible for the administration of incentives designed to promote industrial investment and to correct the uneven development of our economy. However, during the drafting of new legislation there was even a tendency to increase the financial intermediaries' responsibility for administering public-sector grants. This is the case of the proposal that the Southern Italy Development Fund should decide on the request for a subsidy solely on the basis of the information given in the loan contract. Hence the link between credit and subsidy is cut in appearance only, and the fact that there is absolutely no guarantee the subsidy will be granted affects the assessment of the profitability of loan applications and thus, by extension, the decisions to be reached by the credit institutions.

The law governing aid for the reconstruction and development of areas in the South stricken by the eartquake pays greater regard to the distinction in roles between the state and the financial intermediaries. It provides that subsidies to firms that suffered damage shall be distributed by public bodies with responsibility in the area, so that any loans granted will carry interest at normal rates.

The increased capital base of the credit institutions, the legislative changes with regard to special credit institutions, the senior appointments in publicly-owned intermediaries and the amendment of institutions' statutes are improving credit intermediation in a delicate economic situation in which the interest of the productive sector calls for a more stable and efficient financial system.

Ladies and Gentlemen,

This attempt to recount recent economic events in full and to report on the work of the Bank will not have concealed the tension felt as these events unfolded nor our concern at the difficulties facing the economy, which are exacerbated by occurrences elsewhere.

Besides the valuable legacy of a growth in investment not seen for many years and signs of a renewed sense of commitment on both sides of industry, the year 1980 also left a grave situation for the currency, which is the property of us all, a possession essential for expressing the economic and civil ties that mould us into a society.

Inflation is no longer tolerable when its underlying component rises continuously and alienates us from the countries with which we are linked by history and culture.

Nine years of inflation at not less than 10%, and the last two at around 20%, have not only caused vast and unintended transfers of wealth and created the forms of inefficiency that are due to unpredictable and volatile relative prices; they have also changed the very essence of the currency by largely stripping it of its function as a store of value and leaving it only a humble role as a unit of account and medium of exchange.

A complex trading economy cannot function without a unit of value that is reliable both in the present and with regard to the future. In order to avoid the delusion caused by a currency that is eroding at a rapid and unpredictable rate, such an economy adopts as its yardstick the total of the goods and services it produces, employing a multitude of practices and institutions to do so. In these circumstances even the successes scored by traditional monetary management may prove to be tactical gains incapable of preventing the strategic defeat represented by the consolidation of inflation.

When such a process has been under way for years, it is not by applying the brake of tight liquidity or an unaccommodating exchange rate that equilibrium will be restored. The return to a stable currency requires a real change in the monetary constitution, involving the functions of the central bank and the procedures for determining public expenditure and the distribution of income.

The first condition is that the power to create money should be completely independent from the agents that determine expenditure. There was a time when this requirement arose in relation to the private sector, and it was then that the public law character of central banks and the separation between finance and industry were laid down. Today this requirement should be met primarily in relation to the public sector by freeing the central bank from a situation that allows budget deficits to stimulate an abundant creation of liquidity that is inconsistent with the objectives of monetary growth.

The means by which the central bank finances the Treasury in our system — the overdraft in the Treasury current account, the Bank's practice of acquiring unsold Treasury bills and the subscription of other government securities — should therefore be re-examined. In particular, there is a pressing need for the Banca d'Italia to cease purchasing Treasury bills not placed at the tenders.

However, in a democratic society undergoing rapid change, where aspirations to a higher standard of living are strong, where the social dialectic is intense and where inequalities are still widespread and pronounced, the pressures for the creation of liquidity drive the currency almost irretrievably beyond the limits of stability unless defences are erected in the areas where demand is formed.

The second condition is therefore the existence of rules of procedure that subordinate major expenditure decisions to the need for monetary stability. A fundamental principle of economic and political liberty prohibits the withdrawal of such decisions from the discretion of households, companies and the entire community represented in Parliament and in the government. The very existence of money, a non-specific purchasing power, is an expression of that liberty. Nevertheless, society should order its affairs in a way that prevents expenditure decisions being reached by preying on the common heritage that is monetary stability. To do this, it should lay down the means of choosing without prescribing the choice itself, just as other laws establish the means of action, and hence the very possibility thereof, without laying down its objective.

On the one hand there are household decisions that apportion income between saving and consumption and determine the composition of the latter. Fiscal tools can shape these choices in such a way that they fit into a compatible whole. However, the cause of the destruction of monetary stability lies not so much in households' accounts as in the expenditure decisions of the public sector and decisions concerning the distribution of income within companies. It is here that the relationship between uses and resources is stretched to the point where the increase in prices and the devaluation of debts becomes a necessary perverse instrument of adjustment.

Public expenditure decisions must be made subject to rules that compel substantial respect for the need to match new expenditure by additional revenue. There was a time when consistency between expenditure, the prerogative of the sovereign, and taxes, borne by the people, was guaranteed by the dialectic between the executive and Parliament. The people then became sovereign, and the budget constraint operated for many years according to the rigid rule of balance. The weakening of this constraint has led to a situation in the public finances in which economic equilibrium has no anchorage other than the community's ability to govern itself. The intention of Article 81 of the Constitution was to strengthen this guarantee, but the way in which it has been applied has shown only too often that, far from exerting a stabilizing influence, it has been incapable of preventing expenditure from shaking off the budget constraint. It is necessary to research and define means, such as the requirement to balance current receipts and expenditure, whereby practical expression may be given to the principle embodied in the Constitution.

The expenditure decisions of companies should also be subject to methods and points of reference. In a processing economy, which imports raw materials and exports manufactured goods at international prices, the main cost factor to be controlled is that of labour, with its dual facets of wages and productivity. Our system entrusts control over this factor to management and the trade unions through the system of collective bargaining.

In view of its economic and monetary effects, the immensity of the interests involved and the powers of representation and delegation exercised through it, collective bargaining at national and company level is a true economic force comparable to the mechanism by which public sector expenditure is determined; it is in equal need of criteria that prevent the drift towards monetary instability.

In the same way as any expression of the right to engage in economic activity, the right to negotiate contracts cannot be exempt from the limitations imposed by the interest of the community. Today the very machinery of negotiation, its fragmentation and the failure to accept macro-economic guidelines that would operate as a constraint of general compatibility make it extremely difficult for negotiators to reach decisions that reflect both a fair distribution of income and respect for monetary stability. Institutional arrangements must be sought and defined which restore collective bargaining to its role as an instrument for the determination of wage increases and working conditions rather than for the destruction of the currency.

Less and less faith should be placed in automatic mechanisms that reduce the ability of the negotiating parties to reconcile their aims and prove insensitive to changes in economic and social conditions. When the acceleration in inflation is at its most rapid, it is believed that a surrogate for stability is to be found in the use of indexation; in fact, it is the spread of indexation that endorses and seals the ruin of the currency.

Monetary stability is too precious and fragile a possession for the forces defending it to be weakened by granting individuals and groups the safe-conduct of automatic protection, particularly if such protection is frequent and indifferent to the origin of the inflationary pressures.

In the country of the Community that has been best able to hold prices stable in recent years, the law expressly prohibits any form of indexation, not only in labour contracts but also by means of clauses in individual contracts that would link the pecuniary obligations of the parties to an index of any kind. In the same country this stability, thus confirmed and defended, is also expressed in the ability to transfer money freely across the borders.

Central bank autonomy, reinforcement of budgetary procedures and a code for collective bargaining are prerequisites for a return to monetary stability.

Ten years ago, when even the indirect link with gold via the convertibility of the dollar and fixed exchange rates was cut, the lira, along with the other currencies, became an even more intangible and abstract good, whose value was guaranteed by nothing but the strength of the economy and society's ability to organize itself and to govern.

A monetary code is indispensable for the re-establishment of a stable yardstick by which to measure all present and future goods and as a guarantee against the danger of relapsing into situations that did not help us combat inflation, when they were not actually fuelling it.

These are the problems that the gravity and urgency of the economic situation require us to confront fully in all their complexity. The recent debate shows that the choices are clear in our minds and that positive steps can be taken immediately in the direction indicated. As a matter of urgency, that debate should be translated now into the will for action before it loses momentum. What is required is not so much technical refinements but the ability to cast off prejudices, distrust and the short-sighted defence of individual interests. This ability has its roots in the sense of community, the final irreplaceable defence of a stable currency, as it is that of every other institution in a free and just society.