BANCA D'ITALIA

ABRIDGED VERSION OF THE

REPORT

FOR THE YEAR

1981

PRESENTED BY THE GOVERNOR TO THE

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1982

THE GOVERNOR'S CONCLUDING REMARKS

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III – THE GOVERNOR'S CONCLUDING REMARKS

Last January the Government appointed Mario Sarcinelli Director General of the Treasury. His selection for this high office is a recognition of his exceptional moral and professional qualities and is an honour for the Bank, to which he gave twenty-five years of enthusiastic and devoted service. To every sector in which he worked, ranging from economic research to banking supervision, from electronic data processing to monetary policy, he brought an effectiveness that sprang from his great learning, his acute analytical mind, his ability to reach swift decisions and his firm resolve. Our satisfaction at this significant appointment is mingled with regret that the Bank will be deprived of his rare competence, lively intellect and critical spirit; this is felt most acutely by one who over the years had the opportunity to establish a close working relationship with him that began in the Research Department and became even closer in the Directorate, to which he was appointed in 1976. In him the Bank now has a worthy partner in the search for solutions to the grave problems raised by the economic condition of the country.

A few weeks later the Bank lost Alfredo Persiani Acerbo, who died at the age of 49 after an illness that he had faced with calm composure. He continued to work with total dedication until the very end. His professional life was inspired by a very strong sense of loyalty to the Bank, and the various departments he directed benefitted from his profound knowledge of organizational and legal matters. After joining the Directorate in 1978 he concentrated mainly on internal administration, applying to every issue the sound judgement of his fine legal training, which he exercised with the discretion and elegance of style that were his distinguishing marks. For him a respect for form was instrumental in combining new ideas with the best traditions of the Bank, which he viewed as a public asset to be preserved and enhanced.

These voids stemming from such different causes were filled by appointing Antonio Fazio and Carmelo Oteri Deputy Directors General.

The Bank mourns not only the death of Alfredo Persiani Acerbo but also those of Giuseppe Manuti, Head of the Treasury Relations Department, and Franco dell'Uva, Head of the Data Processing and

Information Systems Department, who were likewise in their prime. It is said that institutions have a life transcending that of their members. The Bank has the necessary professional resources within its ranks, even in difficult times of transition. However, this does not lessen our sorrow at the irreparable loss of the human qualities of our departed colleagues.

Last year the work of improving the efficiency of the Bank continued.

The most significant measures adopted were the introduction of a large-scale programme of new accounting procedures, the automation of the management of securities held on deposit, the reorganization of the Cashier's Department, the simplification of branch organization and, in the large branches, the establishment of intermediate levels of management and the creation of research groups to enable operational decisions to benefit from analysis of local economic conditions.

The innovations introduced in internal arrangements are themselves evidence of the commitment of the management and staff of the Bank to serving the interests of the community. We wish to express our warmest appreciation for their contribution.

The world economy

The world economic scene is dominated by a recession that is lasting much longer than initially forecast and by inflation that is still high, though declining. There are now 29 million unemployed in the OECD countries. The rate of inflation has slowed down from 14 to 9 per cent in the last two years; the improvement has been particularly marked in the three main economies. The continuation of the recession and the scale of unemployment underline the cost of curbing inflation if it is not attacked at the roots by means of a consistent set of measures.

The current account balance-of-payments deficit of the OECD countries has contracted sharply, as has the surplus of the OPEC countries. By contrast, the external position of the developing countries has deteriorated and the difficulties facing the centrally-planned economies have become more acute. The problems of international indebtedness have grown worse.

According to current OECD forecasts, economic activity should begin to pick up in the second half of the year, assuming that domestic demand expands in the United States and Japan. A year ago this was expected to occur towards the end of 1981, but in the third quarter the US economy suffered a relapse and recently Japan's gross domestic product contracted slightly after seven years of uninterrupted growth. In the Federal Republic of Germany the level of production is also continuing to fall.

High US interest rates and the strength of the dollar, fuelled partly by the current account surplus, have created a dilemma for those industrial countries that would be in a position to relax their restrictive stance but for the fear that their economies would come under external pressures that would wipe out their hard-won gains in the fight against inflation. Moreover, in the developing countries, in particular, the burden of indebtedness has been exacerbated by the extremely high interest rates and is in danger of compromising adjustment programmes and the potential for growth, which would have repercussions on the industrial countries as well.

The new US Administration based its economic programme on the achievement of three main objectives: a reduction in inflation, the restoration of a balanced budget and the stimulation of economic growth through the expansion of private saving and productivity. In the choice of instruments, reliance was placed on a monetarist approach on the one hand and on the elasticity of the productive sector's response to cuts in personal income tax, to investment incentives and to a reduction in government regulation on the other. The Administration's confidence in the markets' ability to find equilibrium indicated, as a corollary, that it should refrain from interventions to steer or smooth foreign exchange markets.

Considerable success has been achieved in reducing inflation and changing attitudes in the labour market, where unions have paid greater heed to the employment effects of their wage claims. Business has so far failed to react to the fiscal stimuli and the effects of deregulation. During 1981 a sharp decline in investment and exports was accompanied by the stagnation of private consumption. This helped to inflate the Federal budget deficit, which was initially set at 45 billion dollars for the current fiscal year. The latest official estimates put it at about 100 billion dollars, an amount equal to only 3 per cent of gross domestic product but which would absorb more than two thirds of households' saving even if the ratio of saving to disposable income rose to 7 per cent, as predicted by the OECD.

Leaving aside the adverse cyclical trend and the question whether the revenue increases and spending cuts at present under discussion will be approved, the objective of balancing the Federal budget within the next few years seems to have been abandoned. Uncertainty about the deficit is affecting market attitudes. In a country in which inflation has been brought down to 7 per cent, a 15 per cent interest rate on long-term debt is bound to have a prejudicial effect on investment and is indicative of the market's doubts about the feasibility of the announced programmes.

While remaining below the peaks recorded in the summer of 1981, short-term rates rose again in the first few months of this year and approached those at long term. With the budget deficit rising sharply, upward pressure on interest rates has resulted from the determination with which the Federal Reserve is controlling the money supply and the use of techniques based on a particular quantitative aggregate at a time when financial innovation and volatile expectations are changing traditional demand relationships.

The achievements in the fight against inflation in the United States have had their counterpart in the adverse effects on the rest of the world caused by the high and fluctuating US interest rates and the inflationary impact of the steep rise in the US currency, even though the latter has been partly offset by the fall in the dollar prices of raw materials.

The interest rate differentials in relation to assets denominated in yen and Deutsche Mark led to an appreciation of the dollar, thus undermining the competitive position of the United States; the recession and the time required for changes in competitiveness to have their full effect have hitherto limited the deterioration in the current account. The difficulties firms are having in withstanding foreign competition are giving rise to protectionist pressures in the United States; Japan's trade surplus is also arousing alarming tendencies of the same kind on both sides of the Atlantic.

The exchange rate movements of recent months, in particular those between the dollar and the yen, have been due largely to the direct consequences of the different policy mixes pursued – a restrictive monetary stance and an expansionary fiscal policy in the United States and the reverse in Japan.

To those who do not have absolute faith in the ability of market participants always to take uncovered long-term foreign exchange positions of a stabilizing nature, it would seem advisable for the monetary authorities to undertake to carry out concerted interventions in the markets, thereby preventing excessive movements and erratic fluctuations in exchange rates. However, the effects that such interventions would have on the money supply -and on interest rate differentials should not be systematically offset.

In a world that rests on delicate economic equilibria and requires profound structural changes, and hence substantial investment, there is an urgent need for coordination of policies. Greater price stability in the United States will tend to have a positive effect on the propensity to invest both there and elsewhere. In the present state of uncertainty, however, the stimulus to a revival in production, investment and trade must come from those countries that have made significant progress towards adjustment. They would thus begin to reduce their unemployment while safeguarding price stability by means of productivity gains, and would bolster demand in countries that are obliged to maintain or even accentuate their restrictive stance because of delay in achieving adjustment.

The stagnation in the world economy together with energy-saving and diversification policies have caused a decline of 15 per cent in the consumption of oil by OECD countries in the last two years. Oil stocks are now falling, whereas previously they were rising, and imports of oil have slumped by more than a quarter. Since the middle of 1981 there has been a buyers' market in oil, thus temporarily easing the balance-of-payments and inflation problems of importing countries. However, the fall in prices will be counter-productive if it causes uncertainty and postpones measures to reduce energy consumption still further and to diversify and expand the sources of supply.

The sudden and excessive increase in oil prices, which was a factor in the stagnation of the world economy, has backfired on the OPEC countries. In the last two years their exports have fallen from 60 to 45 per cent of the oil consumption of the rest of the world. Their current account surplus may amount to only 15 billion dollars this year, compared with 110 billion in 1980. Those countries in the group able to expand domestic demand considerably are running current account deficits that are unsustainable beyond the short term. As a result, the implementation of their development plans has slowed down.

The reduction in the current account imbalances of the OPEC and OECD countries contrasts with the large and enduring external borrowing requirements of the non-oil developing countries. Although it is difficult to generalize about economies that are often profoundly different, most of them share a common need to step up investment and internal restructuring. However, these are objectives for which it is hard to obtain international finance at present.

Apart from the question of the equitable distribution of resources, the industrial economies must offer tangible support to the strategies of adjustment and balanced growth in the developing countries, which make quite a significant contribution to the formation of world demand. Their imports represent one fifth of the external demand for goods and services from OECD countries and have recorded sustained rates of growth in recent years.

The main contribution that the industrial countries can make to the development of less prosperous countries is to resist and oppose the temptation to resort to protectionism. Furthermore, product specialization and rationalization in sectors that are particularly vulnerable to competition from countries with lower labour costs should be pursued with determination. In order to prevent crises in these sectors it will be necessary to continue to monitor trade relations within international organizations with the aim of encouraging forms of horizontal trade among emerging countries as well.

The Bretton Woods institutions and the regional development banks should be assured of the funds necessary to continue playing their allotted role in the process of international financing. Furthermore, the flow of aid to those parts of the world where poverty is perpetuated by economic stagnation must be intensified, as must efforts to limit assistance that does not serve productive aims.

The increase in the burden of debt and the slowdown in export growth as a result of the world recession have aggravated and hence exposed the inefficiencies in certain centrally-planned economies. In many cases the problem of risk associated with lending to these economies is acquiring political connotations within creditor countries and in their relations with the borrowers.

The management of these credit relations by the banks, supervisory authorities and governments of Western countries is rendered more difficult by the inadequacy of the information available for the purpose of evaluating economic developments and the economic policies pursued. The entry of certain Eastern European countries into the International Monetary Fund must be seen as a positive step, not least from the point of view of improving the knowledge of their economies. The difficulties encountered recently should confirm the international banks in their view that the technical evaluation of a country's ability to service its foreign currency debt represents the main criterion for deciding whether to grant loans.

Against this complex and fragmented background Europe has proved unable to muster either the will or the ability to become a pole capable of taking initiatives commensurate with its size. The divergent budgetary trends, the widening differences in costs — above all labour costs — and the dispersion of inflation rates show that the resolve to achieve economic integration is not being translated into action. Reform of the structure of the Community budget has been impeded by futile disputes and the prevalence of parochial and contingent interests.

Some progress has been made, partly owing to the discipline exerted by the operation of the European Monetary System, but efforts to begin a process of convergence must involve both the budget and production costs in the individual countries. Strains are bound to arise when the major economies pursue different objectives and use quite diverse instruments. The smooth operation and institutional development of the Community's main economic and monetary mechanisms are in jeopardy.

A Europe that is not united in its economic performance and strategy cannot meet the challenge implicit in the creation of a genuine and credible currency unit and the establishment of a true European Monetary Fund with the autonomous power to create ECUs. The lack of fresh initiatives will lead to *de facto* acceptance of the growing role of the Deutsche Mark as a reserve currency. This would cause problems for the working of the EMS and prove a burden for the Federal Republic of Germany that the monetary authorities of that country consider too high. By contrast, the confirmation of the ECU's role as an international currency would give

Europe a greater degree of freedom and would contribute to greater monetary stability.

The cyclical profile of the Italian economy; monetary and exchange rate policies

The stagnation of world trade, the steep appreciation of the dollar and the after-effects of the oil price rise represented a combination of international conditions that were among the most difficult Italy has ever had to face.

The repercussions for the Italian economy gave the currency and the balance of payments a severe buffeting. The upsurge of over 30 per cent in the lira import prices of industrial raw materials lent significant impetus to inflation. The terms of trade deteriorated by 10 per cent, adding some 12,000 billion lire to the trade deficit. Exports of goods showed an increase of 9 per cent in volume terms, of which only around one third was due to the expansion of world demand.

The Italian economy approached the difficult world economic scenario from domestic conditions that were themselves unsatisfactory. Wages were rising strongly, the budget was in increasing disequilibrium, both quantitatively and qualitatively, and despite the cyclical stagnation economic activity was still high compared with that in the other industrial countries, although not in relation to productive capacity. The rise in money incomes was not curbed during the year nor was a start made towards restoring public finances to a sound footing, so that pressures on prices and the external accounts continued to be generated from both these sources.

The gross per capita income of workers in industry rose by an average of 22 per cent in nominal terms and 3 per cent in real terms in 1981. Wages proved impervious to growing unemployment; they were boosted by the indexation arrangements and, to a lesser extent, by previously agreed increases and by settlements at plant level.

The need for rationalization of the wage indexation mechanisms and methods for achieving it were the subject of a debate that was wide-ranging, detailed and rich in interesting ideas, but nonetheless proved sterile. The unions and management have not behaved in a manner consistent with their own approval of the guideline, issued by the Government in Parliament as early as the end of last summer, that wage negotiations should be directed towards the common goal of setting a ceiling on inflation. In other countries, in which economic equilibria rest on a sounder base than in Italy, agreements providing for real wage cuts have been concluded. In some cases, such as that of the Federal Republic of Germany, the unions have consented to them in the conviction that the resulting decline in inflation will provide job security and, before too long, a lasting recovery in purchasing power.

Events bore out the fears that the economy's spending capacity would be fuelled by the budget deficit as a result of the operation of the so-called built-in stabilizers and the effect of the discretionary budget measures adopted in 1980 and also in 1981, in particular with regard to social security contributions and public sector wages and salaries. There was no lessening of the risk that, nurtured by expectations, the perverse sequence affecting public finances, the balance of payments, the exchange rate and prices would get out of hand.

In 1981 public sector expenditure, excluding financial transactions, increased from 160,000 to 207,000 billion lire and its ratio to gross domestic product rose from 47 to 52 per cent; capital expenditure again declined as a proportion of the total. The tax burden increased from 35 to 36 per cent of gross domestic product, owing chiefly to the faster growth in the revenue from direct taxation.

The deficits began to expand again, with that on current spending jumping from 4 to 7 per cent of gross domestic product. Developments also reflected the fact that in 1980 the increased revenue resulting from the expansion of the economy had been used to step up spending rather than to reduce the deficit. Net indebtedness totalled 50,000 billion lire, compared with 31,000 billion in 1980, bringing its ratio to gross domestic product to 13 per cent, compared with 9 per cent the previous year. This ratio is the highest recorded since the Second World War and it exceeds that for the other major OECD countries by an abnormally large margin.

When pressures were at their height, firstly in March and thereafter in June, the Government reaffirmed its determination to keep the domestic borrowing requirement within the limits of the 1981 forecast of 37,500 billion lire. However, the borrowing requirement expanded further in the second half of the year, despite the recourse to liquidity operations designed to mop up the deposit balances that the decentralized spending agencies held with the banks.

The international situation, Italy's position in the world economy and the uninterrupted operation of domestic factors of instability made it necessary for monetary policy to maintain a stabilizing course in close coordination with exchange rate policy.

The problem of the compatibility of the economic objectives pursued was particularly manifest in the case of exchange rate policy. The acceptance of a lira depreciation beyond certain limits would have jeopardized the fight against inflation. The line followed has been designed to secure an appropriate trade-off between the need to reduce the current external payments deficit and to oblige companies to seek cost savings and productivity increases. By contrast with the situation in June 1980, the parity changes within the EMS were decided at times when unused productive capacity made it possible to reap immediate benefits from the realignments.

The effective lira exchange rate declined by 13 per cent on average in 1981, primarily on account of its depreciation against the dollar. Vis-à-vis Italy's nine major competitors, the fall amounted to 9 per cent. The competitiveness of Italian goods improved by 3 per cent, thus partially offsetting the deterioration recorded in 1980.

In the course of the year, fluctuations in the lira exchange rate were greatest after the March and October realignments within the EMS. However, even in these particularly crucial, difficult phases exchange-rate-induced changes in competitiveness were not such that firms could count on profit margins being restored by that means. During the first five months of 1982 the lira depreciated by 2 per cent against the other Community currencies and by 7.7 per cent against the dollar.

Alertness to developments has in the various stages made it possible to coordinate monetary and exchange rate policy, to modulate the impact of policy instruments as well as to give a full account of the country's economic situation in the fora for which institutional provision is made. The course of events has confirmed the view that fundamental imbalances have developed, whose resolution on anything more than a temporary basis requires the adoption of forceful, well structured policies.

The preconditions for an easing of the monetary and credit restrictions did not materialize, both because the external difficulties persisted and because other policies were inadequate. On several occasions the authorities had to respond to the need for prompt countermeasures to hold down liquidity and the pressures on exchange rates and prices, in the knowledge that if intervention were delayed the country would face an exchange rate crisis and rising inflation.

Action to change the ceiling on bank lending was taken in January 1981, and in March the discount rate and the compulsory reserve ratio were modified. At the time of the March parity realignment the blueprint for an economic policy programme involving intervention on a number of fronts was yet again reduced to the use of the monetary and exchange rate instruments, since Parliament had rejected all or part of certain provisions designed to cut the deficit.

In May both credit policy and exchange rate policy were again obliged to rely on an administrative instrument, namely the deposit on foreign payments. When the decision to introduce the scheme was made, the rapidity with which it would delay such payments, its effect on liquidity and hence on companies' propensity to import prevailed over arguments relating to its unequal allocative effects. The scheme was renewed in a less severe form in September and was discontinued in February 1982. It was terminated early so as to reduce the impact of the expectations connected with the anticipation of its expiry at a known date.

In view of the obstacles impeding progress towards concerted control of incomes and the restoration of a balanced budget, the ceiling on bank lending was again renewed in December, on terms that confirmed its restrictiveness. In April, when the foreign exchange markets again came under pressure, measures were adopted to bring export receipts forward and to curb excessive demand for foreign currency; the penalties for exceeding the ceiling on bank lending in foreign currencies were also increased. In recent weeks activity on the Italian exchange market has returned to normal.

Throughout the period under review the rapid and erratic rise in the public sector deficit required the Banca d'Italia to take steps to absorb and to redistribute bank liquidity, which tended to be excessive. It reinforced its efforts when the danger of surplus liquidity undermining the lira's external stability became more acute. The repurchase agreements on the secondary market that had been introduced at the end of 1979 proved to be particularly useful in this connection.

Despite the stagnation of production and the slowdown in inflation, credit demand was sustained by the public sector's greater recourse to borrowing and by the persistence of a rate of capital formation that was relatively high at a time of slimmer profit margins and a reduction in self-financing by companies.

The supply of credit was held down by the ceiling on bank lending as well as by the fact that in 1981 the expansion of the monetary base was kept below 12 per cent. The difficulty of raising funds from the banks resulted in heavy recourse to the special credit institutions and to both the domestic and international capital markets. Overall, the substitution of sources of credit was only partial, and the funds raised were more expensive.

The non-interest-bearing deposit on foreign payments increased corporate demand for funds, thus exerting a restrictive effect at a time when it was particularly imperative to dampen expectations, to curb demand for stocks and to relieve pressures on the exchange rate.

Total domestic credit increased by 73,000 billion lire, as against 63,000 billion in 1980 and the forecast of 64,500 billion made at the beginning of the year. The faster growth was entirely due to the public sector borrowing requirement, which exceeded the forecast and the 1980 outturn by 9,000 and 11,000 billion lire respectively. Credit to the economy was 1,000 billion lire lower than in 1980 and was in line with the forecasts. Even when public sector lending to firms is included, the share of total credit taken up by the economy dropped by 11 percentage points over the year to stand at 45 per cent, thus for the first time accounting for less than half total financing.

The development of interest rates in the course of the year reflected the relative scarcity of credit. The cost of bank loans, which was already high, rose by a further 2 percentage points; the latest data indicate that prime rates are still hovering at around 22 per cent. The rates charged by industrial credit institutions rose by around 3 percentage points, while borrowing on the international markets was also quite expensive. The rise was particularly rapid in the case of medium and long-term securities, the yields on which advanced by 5 percentage points.

The increase in nominal interest rates coincided with inflation rates which were initially stable and which then, from the summer onwards, showed a gradual decline. Real interest rates followed an upward trend, particularly in the second half of the year.

The restriction of credit, in combination with the management of the exchange rate, was decisive for the curbing of the external imbalance. Helped by the improvement in a number of international factors towards the end of the year, it also made it possible to score a certain degree of success in the fight against inflation.

Despite the adverse influence of an oil import bill that increased by 8,000 billion lire in a year and the general deterioration in the terms of trade, the trade deficit diminished by 1,200 billion lire. The current account deficit rose from 8,300 to 9,200 billion lire, owing principally to the higher cost of servicing the country's external debt, which totalled 48 billion dollars at the end of 1981. At that date Italy's external debtor position, net of financial assets, totalled 13 billion dollars, while its gold reserves were worth the equivalent of 29 billion dollars.

The current deficit declined substantially in the course of the year, falling from more than 3,000 billion lire in the first quarter to under 1,000 billion in the fourth. As the data for the last few months confirm, this figure overstates the shift, since it reflects the partly reversible impact of special measures and factors. Italian companies won back some of the share of world trade they had lost in 1980, but the recovery occurred in the dollar area and above all on the OPEC markets, whose dependence on the vicissitudes of the oil surpluses makes them volatile. By contrast, European markets continued to be difficult to penetrate.

The twelve-month rate of increase in consumer prices slowed gradually, dropping from 21.5 per cent in the fourth quarter of 1980 to 18.3 per cent in the same period of 1981. In the first quarter of 1982 it amounted to 17.0 per cent and by April it was down to 16 per cent. There was a reduction in the role of the cyclical component of inflation, which had been significant in 1980. Inflationary expectations abated, but they remain high. The improvement in the case of the wholesale prices of manufactures was primarily due to a squeeze on profit margins, which occurred against a background of a rise in unit costs that exceeded the 1980 rate by 3 percentage points.

Gross domestic product and industrial output showed small average declines in 1981, although they fell by less than in the major industrial countries; in the course of the year the profile of economic activity was virtually flat. The propensity to save was buttressed by rising real yields on financial assets, and its tendency to decline was arrested. As far as the composition of demand is concerned, the positive shift in the trade balance reflected the slowdown in investment in stocks, in particular of raw materials and semi-finished products.

The crisis had particularly serious repercussions for the labour market. In the fourth quarter the unemployment rate, adjusted to take account of workers receiving benefits from the Wage Supplementation Fund, was close to 11 per cent, compared with 9 per cent in the last quarter of 1980. The rate represents a peak for Italy, although not for other industrial economies. The rise in unemployment is largely attributable to demographic and social factors, which are causing the labour force to expand. In the course of the year there was, however, a drop of 120,000 jobs in industry, which is the largest decline recorded since the beginning of the seventies.

Developments in the early months of 1982 and the short-term forecasts that can reasonably be made confirm that a more rigorous approach needs to be adopted if there is to be a lasting improvement in Italy's economic situation.

We should not overestimate the progress made so far. Although the economy is in the trough of the cycle, inflation is very high and further attempts to reduce it will come up against the deep-seated structural causes of inflation. The trade deficit has increased again, albeit owing to special factors, and in the first quarter of 1982 it was larger than in the year-earlier quarter. The public sector borrowing requirement for the first five months of the year may be preliminarily estimated at 27,000 billion lire, compared with 20,000 billion for the same period of 1981. In the second half of the year the customary increase in funding needs will be aggravated by factors, in part attributable to recent decisions, that will augment expenditure and slow the inflow of receipts. The borrowing requirement that is building up month by month is not in line with announced economic policy, despite the fact that the Finance Law exercised a moderating effect; this means that, as was the case last year, the quantitative objectives indicated for the growth of total domestic credit, which were based on a public sector borrowing requirement of 50,000 billion lire, are no longer relevant.

Monetary policy and exchange rate policy have succeeded in steering the economy along a very narrow path. The productive sector is in a position to respond to a world economic recovery. The capital formation of the last three years has established the preconditions for further penetration of international markets. An upsurge in labour costs would negate the contribution that the increased volume of investment has made to the strengthening of Italian competitiveness and would prevent benefits being derived from it at the level of employment.

Balance-of-payments equilibrium could be restored if we can succeed in capitalizing on the upswing in world demand that is expected to materialize in the autumn. If before then domestic demand were to be rekindled by consumer expenditure, fuelled by the public sector deficit and the upsurge in wages, the progress made towards external adjustment would be compromised and the pace of inflation would accelerate again.

The state of the Italian economy demands that the cyclical pattern should correspond to that in the major industrial countries which will require a rigorous budgetary policy and income restraint. The risk that the world economy might stagnate for longer than anticipated makes a commitment follow these guidelines more, rather than less, imperative.

The structural difficulties of the economy

In a difficult year Italian firms once again gave proof of their vitality by making fixed investment and by winning new customers for their exports. The active search for responses to the crisis of the last decade has spread from small firms and the so-called underground economy to medium and large-sized firms, above all in the private sector. The need for a similar approach is also emerging in state-controlled companies; the restructuring programmes that have been developed are designed to achieve adjustment to market conditions and a return to sound cost/price relationships.

However, the progress made to date in the use of the three essential productive resources of capital, energy and labour has been inadequate and uneven. The economy has not yet come to grips with the structural problems besetting it, on which we have dwelt in the Annual Reports of the past few years.

As a percentage of gross domestic product, fixed investment at constant prices fell virtually without interruption between 1970 and 1978, dropping from 24.4 to 18.9 per cent. The subsequent recovery boosted the ratio to 20.1 per cent in 1980. The rate of capital formation showed no change in Italy in 1981, whereas it declined in the majority of industrial countries. Partly because of the manner in which the credit squeeze worked, the corporate sector's main reaction to it was to run down stocks. The modernization of production was continued through accelerated depreciation, and the capital stock per worker continued to increase, in line with the long-term trend in the industrial economies. The rise in the proportion of fixed investment accounted for by purchases of machinery and equipment is an indirect indicator of the tendency towards the rationalization rather than the expansion of the productive base. This is reflected and further confirmed by the behaviour of hourly productivity, which increased by 3 per cent in industry in a year of recession, to some extent because of the greater flexibility in the use of labour.

These developments bear witness to the corporate sector's efforts to adjust to a structure of prices and costs that changed radically in the course of the seventies. The vitality of firms and their attendant growth prospects are the best guarantee for employment. Under present conditions wage restraint is an essential prerequisite for securing that vitality and for ensuring that investment is once again primarily channelled into additional capacity and is not geared solely towards labour saving.

Information concerning the qualitative development of Italy's industrial fabric may likewise be gleaned by looking at its foreign trade. In the case of trade in manufactured goods, the achievement of a surplus more than twice as large as that seen in 1980 was due in large measure to the growth in export volumes. That growth was concentrated in the textile, clothing and mechanical engineering sectors, but the timber and furniture industry, the skins and leather sector, vehicles and certain branches of the metalworking industry also made a positive contribution. Many firms operating in these markets have shown that they are capable of technical innovation and organizational improvement. On such markets the only way to withstand the effects of the stagnation of world trade and the growing competition from the newly industrialized countries is to enhance specialization in products and productive processes and to curb costs.

The way in which Italy's foreign trade is showing a continuing bias towards so-called traditional goods is cause for concern. Technologically advanced goods make up the same proportion of exports as they did a decade ago; the gap between Italy and the other main industrial countries has widened.-

Since the first oil crisis Italy's energy deficit has escalated dramatically. From 1,600 billion lire in 1973 it climbed to 8,000 billion in 1977, 20,000 billion in 1980 and to almost 30,000 billion last year, when it was equal to 8 per cent of gross domestic product compared with 2 per cent in 1973. From 1979 onwards the group of countries belonging to the International Energy Agency achieved significant successes on three fronts. They stepped up domestic production, brought down the ratio of energy to income and reduced the proportion of their total energy needs met by oil. Italy could not be a party to the first development, but the IEA countries as a group increased their energy production by 8 per cent between 1978 and 1980, with the result that the imported component of their total energy supplies, which at 33 per cent had already been way below the Italian figure of over 80 per cent, was cut to 28 per cent. The reductions in the income elasticity of energy demand and the relative importance of oil did extend to Italy, where the initial imbalances had, however, been far more pronounced. Energy savings were secured by streamlining energy-intensive industries and changing the balance between the factors of production.

In the last three years most of the industrial economies, including Italy, have raised domestic energy prices more closely in line with the oil price rise than they did in the aftermath of the first oil shock. However, the reduction in Italy's energy consumption per unit of output has been only half that recorded in the other IEA countries, although the latter began from a higher initial base. In view of Italy's greater dependence on oil and other imported sources of energy, more forceful, wider-ranging action would have been necessary. Awareness of this delay inspired the recent National Energy Plan for the eighties. Its implementation is now essential.

Weakness in a country's productive sector is reflected not only in its external accounts but also in its performance with regard to prices and employment, particularly when the economy is exposed to external or internal shocks. Such shocks have been the rule rather than the exception during the last decade, in an economic environment remarkable for the rapid succession and interaction of changes in exchange rates and raw material prices at the international level and in the development of wages and public sector finances domestically. Movements in relative prices are thus set in motion which are influenced by the varying sectoral impact of costs and the differing market power of firms. The asymmetries and rigidities present in the markets foster inflation and aggravate the imbalances in the productive fabric even between units that belong to the same branch or are located in the same region.

Among the manufacturing companies whose balance sheets are surveyed by the Banca d'Italia, the indices of gross profitability and indebtedness are scattered very widely around the mean and their range has been increasing steadily since 1974. The percentage of firms in fragile financial health is extremely high in certain sectors, and the system's internal interdependences are such that some of the sectors concerned are capable of exerting a substantial impact on production and employment throughout the rest of the economy.

These problems can be resolved only through a process of the reallocation of resources that involves the composition of demand and production, the size of companies in all sectors and the balance between the factors of production within individual companies.

It is not for the central bank to take measures relating to the sectoral allocation of resources, even if it cannot remain oblivious to the internal set-up of the productive system. In a mixed economy the restructuring process is the net result of the combined operation of autonomous mechanisms, which are predominantly market based, and of industrial and institutional policy measures, the need for which has been stressed in this forum on several occasions. However, such factors can have their full effect only if certain more general requirements concerning resource mobility are met.

The need for labour mobility has found an outlet in recourse to the Wage Supplementation Fund for purposes transcending its original functions. Since the middle of the seventies the total number of hours for which benefits have been paid by the Fund has followed an exponential growth curve. The trend is essentially attributable to so-called extraordinary interventions, which increased sixfold between 1975 and 1981 in terms of the number of hours involved; the ordinary interventions have performed their institutional role as anti-cyclical stabilizers, relieving firms of a large portion of the cost of labour for which they temporarily have no need, without depriving them of the skilled personnel they will require when production picks up again.

The extraordinary interventions have also restored the corporate sector's margins of flexibility, which had been eroded by other developments in the industrial relations field, and have maintained the incomes of industrial and office workers. There is, however, increasing doubt about the extent to which the Fund's extraordinary interventions conform with their institutional purpose, which is partly to facilitate the movement of labour into other sectors and firms, in line with the trends prevailing in the productive system but subject to appropriate industrial policies. The interventions have too often consisted merely of transfers of income, degenerating into a permanent subsidy to hidden unemployment, encouraging the underground economy, undermining equitable wage distribution among employees and, ultimately, acting as a brake on mobility. These drawbacks may be put down to the shortcomings of the Fund as well as to the time it takes for industrial policy guidelines to be defined and implemented.

The absence of time-limits on benefits, the cursory examination of the merits of individual cases and the fact that the financing mechanisms are open to abuse by firms are all aspects that need to be corrected. Action on this front is no less urgently required than the reform of the other institutions that regulate the labour market.

Steps also need to be taken, particularly at the level of education, to counteract the growing resistance to certain occupations, both self-employed and otherwise. The vocational guidance initiatives that have already been proposed deserve swift approval.

Housing construction is another central problem of resource allocation. Labour mobility cannot be achieved in practice if the inherent reluctance to move is exacerbated by difficulties in finding new accommodation. Over the years three disturbing phenomena — the shortage of dwellings in the main centres and the increase in the construction of holiday homes, the exceptionally steep rise in property prices and the virtual disappearance of a genuine rental market — have assumed massive proportions. Owners are deterred from renting property by a body of legislation which, despite the removal of rent controls as a result of the Fair Rent Act, tends to recreate earlier limitations on the availability of accommodation.

The housing problem should be attacked both by promoting the supply of new dwellings, which are most sorely lacking in the rental sector, and by fostering the more efficient use of the existing housing stock. Owners should be assured of repossession of their property when leases expire and the tax system sh[illegible]de more consistent with the need to facilitate property tr[illegible] the lines of recent tax measures; in addition, the authorities should seek to speed up their administrative procedures in the housing field and to hold down building costs in the public sector.

The precariousness of the frame of reference for economic decision-making is not limited to the housing sector. It stems from the profound changes that have occurred in recent years in the prices of goods and factors, in exchange rates, in interest rates and, more generally, in the institutional context within which the economy operates. Economic agents are obliged to take decisions in more uncertain conditions. One expression of this uncertainty is the occasional tendency for regulative activity to produce legislation which, under the pressure of the urgent need to act, fails to take full account of the systematic links and results at times in unclear rules and ambiguous objectives. The task of interpreting and implementing legislation has therefore become more difficult.

Taken together, these various causes of uncertainty impose additional burdens on the economy and society on account of the "insurance" that has to be taken out against them. Inevitably, the possibility of mistaken choices increases, the time horizon is brought closer and measures already taken have to be revised more frequently. The greater the uncertainty, the more circumscribed production and investment decisions become.

The path to monetary stability

The reinstatement of the government budget as an economic policy instrument may be considered to form the apex of a triangle that represents the elements necessary for the restoration of a sound currency; the other two corners are the consistency of behaviour affecting wage determination and the independence of money creation from the centres of expenditure.

Government spending grew rapidly and indiscriminately in the seventies. Last year for the first time its ratio to gross domestic product was higher than that recorded in the major European countries, while revenue remained appreciably lower.

It is rightly maintained that Italy's below-average per capita income has to be taken into account when evaluating the ratio of taxation to gross domestic product. However, the same reasoning should also be a *prima facie* argument for curtailing expenditure until per capita income has reached a sufficiently high level.

If the deficit had been caused by an investment drive to expand and strengthen the productive sector and hence to generate future income, it could be assumed that the gap would eventually close. However, the excess of current payments over receipts accounts for more than half of the shortfall; by contrast, the other major industrial countries recorded a current budget surplus in 1981.

The close links between monetary policy, the public sector borrowing requirement and the ways in which it is financed, which have recently been the subject of close theoretical examination, can essentially be reduced to one elementary principle: no economic entity can allow current expenditure to exceed revenue for long. The budget constraint forces individuals and firms to adjust; the State's unique position as a borrower enables it to postpone the day of reckoning, but not to avoid it indefinitely. Any attempt to do so cannot but increase the perverse levy of inflation.

There must therefore be a return to the respect of principles that place direct and binding limits on the systematic absorption of savings by the public sector.

The requirement to balance the current account of the budget would activate mechanisms for verifying the validity and volume of expenditure, thus leading to a direct cost-benefit analysis of the services demanded of the State. This would also avoid the postponement of real solutions to the underlying problems of the economy, which is often encouraged by the ease with which the cost of delay can be shifted to the public sector.

As a first step towards balance, a closer link needs to be forged between the annual and multi-year budgets; the latter should be the outcome of a careful assessment of revenue and expenditure that is consistent with the expected performance of the economy. The first principle that should be established, in the spirit of Article 81 of the Constitution, is the requirement that any current expenditure over and above that for which the multi-year budget already provides should be fully covered by tax receipts, both in the current year and thereafter.

The task of increasing the total tax burden should certainly not be left to the automatic effects of inflation and fiscal drag, but it would be unthinkable to neutralize the progressiveness of the tax system while at the same time ignoring the overall dimensions of the problem. Not only must the battle against tax evasion be resolutely intensified, but sectors that have managed to obtain exemption should be brought back within the tax net.

Serious financial problems are developing in the social security system and the health service. Unless decisive action is taken, these will place an intolerable strain on resources within a matter of a few years, particularly as the average age of the population increases and the automatic adjustment mechanisms, some of which were introduced only recently, gradually exert their full effect. Control over health service expenditure is being lost as a result of decentralization; the criteria for imposing cash limits on the local health authorities are unclear and the overspending that is accumulating is ultimately being passed on to the central authority, whose power to intervene is limited.

Nothing significant will be achieved unless the pretence that the State can and should supply the citizen's every need is abandoned. Reforms that do more than rectify the present anomalies are essential. They will need to be based on the distinction between essential services, to be borne by the community, and supplementary forms of voluntary health insurance purchased with private savings, as in almost all EEC countries.

Despite the high level of government expenditure, public services in Italy continue to be inadequate or severely deficient. The solution lies not in endlessly increasing the number of staff but in striving for efficiency and improving the services.

Although the public utilities should not be placed under an absolute obligation to cover their operating costs out of receipts, there should be rigorous examination of the cases in which it is in the public interest to allow certain services to be sold at prices below cost; subsidies should form part of current expenditure and they should be clearly identified, defined in amount and linked to the services provided, rather than simply reflect the retroactive financing of a deficit. Credits to state-controlled companies, which are at present entered in the capital account, relate only partly to true investment – some of them are used to cover operating losses. Here too the books must be set straight.

Interest on debt is the item of public expenditure that has shown the fastest growth in recent years; in 1981 it totalled 30,000 billion lire, having tripled in the space of four years. The increase was caused both by the rise in interest rates and by the expansion in debt, which had risen to 275,000 billion lire by the end of the year.

It is maintained in some quarters that the adjustment should begin with measures to reduce interest payments; one school of thought suggests easing the control on the growth in the money supply while a second holds that public debt should be indexed to price developments in such a way that the burden of servicing charges would be concentrated at the redemption date of the securities.

The answer to the first proposal is to be found in the remarks made earlier regarding the economic situation in Italy and abroad and the reasons for which a strict monetary stance must be maintained. It is important not to confuse the primary causes of the deficit and inflation with their secondary causes nor, worse, to confound cause with effect. Positive real interest rates check domestic demand and encourage the accumulation of financial assets. They too are cost factors, of course, and any increase in rates has undesired effects on inflation, but their impact is much smaller than the opposite effect obtained by controlling demand and supporting the exchange rate. Nor should it be forgotten that negative real interest rates subsidize borrowers at the expense of lenders.

We also remain opposed to the indexation of public debt to the level of prices, although we subscribe to its aim of treating savers fairly. However, fairness must be achieved by ending the erosion of savings, not by promising fruits that will never form on the barren plant of a chronic current budget deficit.

The aims of reducing uncertainty for lenders and borrowers alike and encouraging medium and long-term lending can be pursued without extending indexation to new fields. Floating rate loans, which the Bank promoted and the market then perfected in innovative ways, have made it possible to keep open the medium and long-term sources of finance to the Treasury and the economy, even in the recent difficult climate.

Apart from debt service charges, which will decline as the economy returns to equilibrium, there are other clearly defined factors at work, mainly in the social security system and the health service, that are destroying the structure of the budget. It is imperative that these disruptive forces be neutralized quickly. Such action would lend decisive support to the fight against inflation both directly and through the impact that credible moves towards rehabilitation of the budget would have on expectations and interest rates. These measures are also necessary in order to curb the increase in the budget deficit due to the different responsiveness of expenditure and revenue to the fall in inflation.

It would be a serious mistake to move towards the indexation of public debt to prices without having first eliminated the fundamental causes of budget disequilibrium. The cost future generations have to pay for the present use of resources would be raised and the stimuli to adjustment would be weakened, thereby exacerbating the overall difficulties.

We are well aware that an economy where much is index-linked and where double-digit inflation has been raging for a decade is in a state of contradiction and that the introduction of new mechanisms of this kind may seem a rational move. However, we reject the idea that in an attempt to resolve the contradiction the economy should once again be pushed towards the veritable abandonment of money implied in universal indexation instead of a serious programme of budgetary reform being launched and the existing degree of indexation being reduced.

Other European countries with automatic wage adjustment mechanisms are moving in this direction in order to restore collective bargaining as an instrument of wage determination. This is the second corner of the triangle that leads to the recovery of monetary stability.

There is a growing realization that a rate of increase in labour costs in excess of that in productivity can only result in the coexistence of stagnation and inflation. The unions and management should undertake to devise a new policy with regard to collective bargaining and to reform the mechanisms that changing circumstances have made obsolete. The protection of real wages should be sought by respecting the rules that produce monetary stability and not by means of practices that trigger a wage/price spiral.

The wage indexation mechanisms work to the ultimate detriment of all: those trying to enter the labour market, who are hampered by the economy's inability to encourage investment designed to expand productive capacity; those in work, who pay for the attempt to protect real income by having to endure increasing uncertainty about the security of their jobs; the trade unions, whose scope for wage claims is reduced by the automatic element of increases and which are suffering the effects of decisions that make the prospect of higher employment more remote.

The third corner of the triangle of conditions for a return to monetary stability consists in restoring the central bank's full autonomy in the creation of money. There are those who believe that the exercise of this autonomy in an uncompromisingly restrictive way is a sufficient condition to ensure stability and contain the budget deficits. That theory may have been valid when markets reflected perfect competition and government played a far more limited role than it does now, but it does not hold good today. There is no invisible hand rapidly and lastingly stabilizing wage growth and the budget deficit in response to monetary control.

A tight credit policy reveals the disparity between demand in money terms and real growth and between the public sector borrowing requirement and the propensity to save. It is therefore of fundamental importance that the central bank be able to exercise full control over monetary and financial flows, particularly when budget deficits are large and growing larger.

An important step forward has been made by terminating the practice whereby the central bank acquired any Treasury bills not taken up at auction. The severance of the link between the Treasury and the Banca d'Italia, which will be completed with the introduction of competitive auctions, does not in itself resolve the underlying problems, but it does permit better compliance with the principle embodied in the Constitution that the direct monetary financing of the budget deficit be subject to precise limits.

The independence of monetary policy decisions from those relating to management of the public debt should not be interpreted as a rigid separation in the performance of the two functions. The composition of financial assets according to maturity and yield characteristics influences the behaviour of economic agents by affecting expenditure and capital movements across the exchanges.

Monetary and debt management policies must be mutually compatible if the optimum trade-off is to be achieved between money supply objectives on the one hand and minimization of the cost and lengthening of the maturity of public debt on the other. Distinct as their tasks are, the Treasury and the Banca d'Italia continued to act in accordance with these criteria even after the Bank had ceased to be obliged to take up newly issued Treasury bills that had not been placed in the market.

Nevertheless, should the destabilizing influence of the budget deficit become particularly strong, the central bank will be obliged to give priority to the objective of controlling the money supply at the expense of the desire to lengthen the maturity composition of public debt. Monetary control is the key factor in curbing inflation and it is only by halting the debasement of the currency that the authorities can attract the public back to long-term securities and comply with the imperative of protecting savers.

The banks and financial intermediation

The rapid decline in the banks' share of total financial intermediation continued in 1981 and is still proceeding. In the course of the year bank deposits rose by 9 per cent, a rate of increase that was not only lower than that in prices but also below average deposit rates.

The attention and, not infrequently, the concern of bankers have been focussed on disintermediation. Until now emphasis has been placed on the quantitative aspects of the development of intermediation in the narrow sense. However, this is only a partial and imperfect measure of banking activity; banking services other than intermediation proper have shown strong growth overall and the composition of both parts is undergoing rapid change.

Empirical analysis based on historical and comparative data has identified a tendency for the role of the banks in overall intermediation to decline, albeit with wide fluctuations, as the economic and financial development of each country advances. In the case of Italy this secular trend has been less distinct and was actually reversed between 1970 and 1977. During that period all the indices of banking intermediation showed continous and appreciable increases to exceptionally high levels. The subsequent decline has rapidly gathered pace in the last two years. Banking intermediation measured in relation to total financial assets and liabilities is nonetheless at a level similar to or higher than that recorded in the first half of the seventies.

Although some aspects of the developments in recent years reflect a natural trend towards a better balance between bank and non-bank intermediation and stimulate efforts to achieve greater efficiency in the financial sector, concern is aroused by certain qualitative as well as quantitative features of their causes and effects.

Bank deposits have lost ground in relation to other financial assets held by the public, such as government securities and in particular Treasury bills, holdings of which rose by 70 per cent in 1981. This form of competition inevitably becomes particularly fierce when a rise in the budget deficit coincides with a restrictive monetary policy stance. This has been the case in the last two years. The fall in intermediation by the banks was largely a manifestation of the more general crowding-out of all other activities by the public sector. The banks themselves would be in a position to lend to the State, but their involvement would be more expensive for the borrower than direct access to savings and would seem to have little point, as the maturity and risk transformation by the banks that is required for private credit is much less necessary in the case of public debt.

However, the banks have also been affected by competition from the other financial intermediaries and by the direct placing of corporate debt on domestic and international markets. In particular, the special credit institutions have played an active part in the recent phase of more intensive fixed capital formation, having overcome the problems that beset them in the second half of the seventies. Their activity has recovered significantly, partly owing to their freedom from lending restrictions and partly because of the more varied forms of fund raising.

The banks' market share has been squeezed primarily by the restrictive stance of monetary policy. Official controls and the tax treatment of financial instruments have impeded the banking system's response to competitive pressures. A further constraint has been the slowness with which interest margins have narrowed, caused to some extent by the limited ability of the banks to increase profitability by holding down costs.

The necessity for the ceiling on bank lending derives from the framework of macroeconomic objectives and conditions within which credit policy has to operate. Although it has quite often given the banks both an incentive and an opportunity to rid themselves of less reliable borrowers, it limits and distorts competition. By restricting and standardizing the expansion in lending, it tends to sap the strength of the most viable component of banking activity.

There are many ways of organizing a money economy and directing savings towards investment projects, but there is essentially only one way of selecting firms that deserve to be given what Schumpeter called the "command" of resources, and that is the assessment of creditworthiness.

In a phase of radical restructuring in the productive sector it is therefore vitally important that the banks should continue to apply sound financial criteria to the granting of loans and, in so doing, to use the best entrepreneurial skills and ample technical facilities.

In order to safeguard the separation between industry and the banks that underlies banking regulations, the assessment of loan applications must be based on the ability of firms to service their debt rather than on the financial intermediaries' predetermined attitudes towards particular sectors. The banks' role is to view individual investment projects primarily as future sources of profit and cash flow for the firm as a whole. Loan diversification within the limits of the banks' competence should be seen not as a form of insurance but as a deliberate portfolio choice based on a prudent attitude towards risk since guarantees play a subsidiary role.

Even the most advanced theories of banking science can give the banker only partial support. The ultimate choice is necessarily the result of a chain of decisions in which he must exercise independent judgement throughout. Assessment of the probability that a loan will have a particular outcome inevitably entails a degree of subjectivity. The risk that the granting of a given loan implies for banks with different characteristics varies according to the degree of correlation between the expected yield on the loan and that on their other assets. A bank's attitude towards the yield and risk characteristics of its loan portfolio is influenced by its size, type, location and operational approach.

In view of such intrinsically subjective factors, any evaluation of banking entrepreneurship has to refer back to the conditions prevailing when the decisions were taken and appraise them in the light of the need to obtain and process information and ascertain the extent to which decision-making conforms with the operating guidelines of the bank in the various markets in which it is engaged.

The various factors to which we have referred prompted the banks to channel funds towards other intermediaries under their control or influence. The phenomenon also extended to the special credit institutions, in particular by means of cash advances. Economic agents not associated with credit institutions also stepped up their fund-raising activities in 1981: the volume of so-called "atypical" securities, excluding shares in investment trusts, increased by 600 billion lire to total 1,600 billion at the end of the year. The overall flow of funds generated in these ways was quite significant, even if not so large as to jeopardize the control of credit to the economy.

It will to a large extent be possible for these activities to continue to develop even in the absence of the favourable conditions they have enjoyed until now. The range of financial instruments and services will thereby be enhanced and the advance of other countries' credit structures over those found in Italy will be reduced. The scale of the phenomenon and some of the features it is acquiring, particularly where "atypical" securities are concerned, call for special rules to protect savers and to guarantee the professionalism of market operators.

The solution to the problems confronting the banks should be sought in the elimination of the root causes of distortions, rather than in measures that offer compensations to the banking system. The general state of the economy does not at present allow an easing of administrative constraints, but in the meantime reforms designed to equalize tax treatment and institutional status would be opportune.

In the highly diverse parabanking sector, the demarcation lines between credit circuits and other activities should be drawn more distinctly. The transparency and orderly functioning of all sectors of the capital market need to be assured, without discouraging new initiatives. These are the goals pursued in the legislative proposals on investment trusts and "atypical" securities now being considered by Parliament.

First and foremost, it is the responsibility of the banking system to increase its own capacity to respond to the competitive pressures to which it is and will continue to be subjected.

The course to follow is that of diversifying the range of services and fund-raising instruments. The necessary preconditions for this are higher productivity, faster internal procedures and interbank communications, the holding-down of costs, which are still relatively high by international standards, and the establishment of a structure of charges reflecting that of the costs of the various services offered by the banks. The latter need to adopt accounting procedures that ensure a more precise allocation of profits and costs to the various categories of activity. Such procedures have already proved their worth in banking systems abroad and although not easy to apply in an industry that typically specializes in joint products they offer the advantage of making it possible for growth markets to be identified more quickly and entered more easily, so that the spread between borrowing and lending rates does not have to bear each and every burden indiscriminately.

There has been a reduction in the correlation between the different yields offered on the various forms of bank deposits on the one hand and their administrative cost and the various preferences of depositors on the other. The interest the banks have recently displayed in certificates of deposit and, more generally, in a more varied range of fund-raising instruments, taking forms and offering rates that reflect the distinction between savings and liquid balances, could effectively counteract the drop in the demand for bank deposits.

A higher yield could be paid on compulsory reserves lodged against certificates of deposit with appropriately regulated characteristics. The return on true savings would thus rise, the degree of liquidity of financial assets would diminish and the banks would be in a position to make better use on the money markets of their virtually exclusive right to create liquidity.

The extension of the banks' territorial networks, the measures that have been taken with regard to the transparency of the ownership and foreign assets of the banks, and the moves involving the statutes of the credit institutions are all designed to enhance competitiveness and efficiency, as well as the stability of banks' net worth.

At the end of March of this year the opening of new branches was authorized under a programme providing for an increase of 5 per cent in the number of banking establishments. The programme was based on criteria for the efficient organization of the networks of banking services and on predominantly quantitative data; both the criteria and the data have been made public. The purpose of the move is to accept a greater number of the applications submitted by the banks, which will thus be expected to act prudently and responsibly in the delicate area of entry into the banking markets.

The need for the consolidated presentation of the risk assets and own funds of all the units in a banking group has been constantly reaffirmed in international organizations, not least in connection with the constant monitoring of country risk and maturity transformation, and it is also recalled in the new rules governing shareholdings by Italian banks. More recently the Banca d'Italia has indicated which information is needed to illustrate the financial links between banks and their foreign affiliates and between foreign subsidiaries and all the companies in the same group. Work has also begun on the definition of reporting schemes designed to reveal the nature of relationships with third parties and to establish the net worth of each group.

As far as the statutes of the public banks are concerned, guidelines have been proposed that are designed to favour capital increases, in particular by means of the taking of minority shareholdings by, inter alia, investors with entrepreneurial skills. These guidelines are being implemented by the banks, which are applying them in the manner best suited to their particular vocation.

These and other developments form part of a critical review of the functions and operating methods of the credit system. The greater the extent to which this review is conducted jointly by the financial intermediaries and the supervisory authorities, the more fruitful it will be. The developments are founded upon the reaffirmation of the concept of the bank as an enterprise. Despite the difficulties still persisting in certain respects, this cardinal principle has, we feel, gained wide acceptance.

Ladies and Gentlemen,

In the world economy the straitjacket of energy prices has temporarily loosened, raw material prices have fallen and many countries have maintained or regained their grip on inflation. Such sources of comfort are outweighed, however, by concern over economic stagnation, unemployment, the contraction in world trade and the divergences in economic performance and policies. The gap is widening between those industrialized countries that have managed to defeat inflation and eliminate their external deficits and those other countries, which include Italy, that are still far from completing either of these adjustments.

Competition is growing fiercer and there is a danger that it will degenerate into unrestrained trade wars fought by using policy instruments for purposes for which they are not intended, ranging from exchange rate manipulation to the granting of assistance and from regulatory control to official pressure. The system of international cooperation on which economic development and social progress have been based for the past three decades is in grave jeopardy.

The existence of an open international arena is essential for Italy's survival. The well-being we enjoy today was created by accepting and meeting the challenge of free trade, and it needs that freedom if it is to endure and to develop further.

The healthy struggle of competition not only requires the economy to strive for greater efficiency and lower costs and to develop new production techniques and products, but extends to all aspects of society and public life. It is a competition in the ability to carry out research and achieve technological progress, between systems of administration, between educational institutions, between different labour market and social security arrangements, between financial systems and between currencies. For a country to compete on an equal footing, an efficient industrial sector is not enough if it is not supported by a modern state administration; an industrious workforce and managerial talent are not enough if educational and professional training is not appropriate to the needs of an advanced industrial society; a strong and deep-seated propensity to save is not enough if the fruits of that saving are channelled to uses that do not generate resources.

On both the international and national levels the currency is the critical element. The strains and instability of the difficult times in which we live are displayed in the three variables of prices, exchange rates and interest rates, through which the fundamental monetary relationships of an open industrial economy are expressed.

Simplistic diagnoses and dogmatic remedies neither shorten nor ease the difficult road to internal and external equilibrium. By laying the blame on just one factor they absolve the many; they encourage moral and civic laxity by masking the fact that monetary stability is a shared responsibility, a good that is never definitively acquired.

The erosion of the currency is an economic deceit, a social contradiction that could be resolved instantly only if the community as a body could instantly transform itself. This is not a miracle that the monetary authorities can perform with the instruments at their command. It behoves them not to make dramatic gestures, but to display tenacity and, if need be, severity in pursuit of their objective and pragmatism in the choice of instruments.

On this occasion last year we stated that after a decade of inflation in double figures Italy would not return to monetary stability without real changes in the institutional arrangements that affect the currency. We indicated that central bank autonomy, greater budgetary discipline, criteria for wage negotiations and a reduction in indexation were the prerequisites for a return to monetary stability.

This analysis and the requirements we indicated have not failed to attract support, and some action has been taken jointly with the Treasury insofar as central bank autonomy is concerned. However, many problems have become more complicated rather than simpler: this is true of public finance, indexation and labour costs. Some progress has been made in curbing the balance-of-payments deficit and reducing inflation, but the 15 per cent inflation rate recorded today is twice the average of the other Community countries and three times the rate in the Federal Republic of Germany, while the balance-of-payments deficit remains high for the third consecutive year.

. Courageous decisions are needed that will also produce quick results, for the market discounts trends as well as absolute levels. The target of single-figure inflation may seem ambitious, but it is a necessary and not impossible goal.

The appraisal of the state of the public finances on the basis of the preliminary results for the first five months and probable developments in the remainder of 1982 calls for cuts in expenditure and increases in revenue in order to keep the deficit for the rest of the year within the limits originally set. The emergency measures will have to be confirmed by launching a programme of action to improve the structure of the budget.

In view of the recent decision to offset fiscal drag, the new increases in revenue will necessarily involve indirect taxation. In order to safeguard the progress already made on the inflation front, the inevitable repercussions on prices must be limited to the initial impact by cutting the link with wage indexation. This is the minimum modification that must be made to the mechanism if, as we have been proposing for some time, economic policy is to regain full use of the indispensable fiscal instrument.

Wage bargaining at national and company level must demonstrate an awareness that in Italy too the dual imperatives of employment and reorganization of the productive sector leave no room for increases in real wages.

It is sad to have to acknowledge the discrepancy between analysis and subsequent action. The paucity of the results achieved hitherto is due not to the ineffectiveness of the action taken but to the failure to reach decisions and to behave in a way recognized to be necessary. We await those decisions and forms of behaviour, and remain determined meanwhile to persevere with the line of conduct that their absence forces upon the central bank.