BANCA D'ITALIA

ABRIDGED VERSION OF THE

REPORT

FOR THE YEAR

1982

PRESENTED BY THE GOVERNOR TO THE

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1983

THE GOVERNOR'S CONCLUDING REMARKS

ROME
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The Banca d'Italia was founded ninety years ago in August. In the first twenty years of the Bank's existence international political equilibrium permitted an increase in prosperity, security and liberty. This period of progress was followed by three decades in which grievous harm was inflicted on the fundamental values of civilized society. Italy was a party to these violent changes, as it was to the subsequent long phase of renewed stability and growth and to the tensions that have prevailed for the past decade; it not only reflected but helped to shape the course of these events, for good or for ill.

Similarly, in its main activities — management of the currency, the control and direction of credit and economic research — the Banca d'Italia has not simply mirrored the events and the features of Italian society: it has also acted as an instrument of economic progress and civic advancement, especially by identifying itself with the latter and displaying a sense of commitment that the serious problems now facing the country require us to strengthen still further.

We have begun a programme of research into the history of the Bank since its foundation. We considered that a review of the events in the life of the institution, even those in the distant past, was the best way to prepare for the Bank's centenary, to make a documentary and analytical contribution to the annals of our country and to enrich the store of knowledge of present and future members of staff and strengthen their capacity for decision-making. This historical research ties in with the intensification of the analysis of current economic trends now being undertaken, the findings of which will be published, starting in the autumn, in an Economic Bulletin prepared by the Research Department.

At this annual gathering we are called upon to give account of a range of activities that vary widely in purpose and in the manner of their execution but which all have the currency as their point of reference.

It is the duty and *raison d'être* of the central bank to act in such a way that the currency is stable and thus provides a certain and orderly framework for economic activity and for society as a whole. This order and certainty have been under threat for some time; the year 1982, the events of which are portrayed and interpreted in the Report that has been submitted to you, brings to an end a decade in which prices increased at an annual average rate of 16 per cent, thereby reducing the lira to one-quarter of what it was worth ten years ago. The Bank in all its aspects, its working environment and the manner in which it performs its tasks cannot but be infused with a feeling of bitter disappointment at this state of affairs.

In an economy rendered vulnerable by a high degree of internal complementarity, where the government budget absorbs more than half of national resources, where a high degree of concentration in the organization of production and labour can have a destabilizing influence on the economic aggregates, the objective of monetary stability tends to move out of the central bank's sphere of influence; the danger can be averted only if society itself ceases to be inured to the steady debasement of the currency and resolves to reject the modes of behaviour, decisions and institutional arrangements that perpetuate inflation.

The duties of a central bank entail not merely carrying out the operations required to achieve price stability with all the determination and technical competence at its command: it must also unceasingly warn that the threat inflation poses for society and for the very institutions of the country is no less serious, yet more subtle, than others that Italy has courageously managed to overcome in recent years.

The Bank's organizational decisions, the definition and management of the activities of the branches and departments and the Bank's staff policy are based on the conviction that by laying increasing emphasis on professionalism in internal management the Bank not only increases the effectiveness of its own operations but places itself in a position to clarify the problems, choices and values that are involved in the smooth operation of a money economy. If it is nurtured and enhanced and coupled with an exclusive regard for the interests of the community, professionalism makes it both possible and imperative to voice the unpleasant truths that must be heeded for the sake of a stable currency.

The world economy — from stagnation to recovery

After two years of stagnation, world demand failed to show the expected signs of recovery in 1982. The stance of economic policy remained restrictive; the recession deepened and spread to all areas of the world. The volume of world trade fell by 2 per cent. Over the last three years the number of people out of work in the OECD area has climbed from 20 to 32 million, or 9 per cent of the work force. Young people are the worst affected group: persons under 25 years of age account for more than 40 per cent of the unemployed. The prolonged recession has had serious repercussions on the developing countries; the contraction in their trade outlets and the burden of high interest rates on a heavy volume of debt have exacerbated their `external financing problems.

Against these costs has to be set the progress that many industrial countries have made in bringing down inflation, which was impeding recovery in the economies concerned and undermining international monetary relationships.

In the United States, the Federal Republic of Germany and Japan the annual rate of increase in consumer prices fell to 3.6, 3.5 and 2.3 per cent respectively in March 1983. In the three major industrial countries inflation has thus returned to the levels obtaining before the two oil crises. In Japan and Germany the slowdown was achieved despite the weakness of the yen and the Mark vis-à-vis the dollar: their ability to curb the growth in money incomes and to prevent a damaging wage/price spiral as the exchange rate deteriorates has increased the. effectiveness and reduced the cost of their stabilization policies.

The slowdown in inflation permitted a substantial reduction in nominal interest rates in the United States and on international markets during the year, although real interest rates remained high.

The forecasts of a recovery in 1982 were based on the assumption of a revival in the US economy. In the early months of the year fears about the present and prospective growth in the Federal budget deficit placed an additional burden on monetary policy, which, in the fight against inflation, is strongly biased towards control of the monetary aggregates. The initial implementation of supply-side policies did not immediately trigger a virtuous circle of recovery, as their proponents had predicted. Far from stimulating private investment, the new Administration's cuts in direct taxation combined with the subsequent increase in defence expenditure to keep long-term interest rates high, thus discouraging investment.

In June a new fiscal policy was gradually introduced that was designed to reduce the deficit mainly by increasing indirect taxation. The measures already taken and those now before Congress have soothed market concern about the Federal borrowing requirement over the medium term but have not slowed down the growth in budget expenditure: current estimates still put the deficit for the 1983 fiscal year at more than $ 200 billion, almost double the outturn for 1982 and the forecast made a year earlier for 1983.

Monetary policy also showed signs of a change, with a more pragmatic approach being adopted towards achieving the quantitative targets. In the summer the payments crisis in Mexico accelerated the transition to a less rigid monetary policy stance, coming as it did at a time of economic and financial strains in the United States that caused failures among businesses and financial institutions. The new approach was made possible by the unexpectedly large fall in inflation. The Federal Reserve considerably expanded the creation of monetary base. In the second half of the year the discount rate was reduced from 12 to 8.5 per cent and the yield on Federal funds came down from 14 to 9 per cent.

Until November the dollar showed a continual tendency to appreciate, even after short-term US interest rates had declined. The strength of the dollar appears to have been due not only to the persistence of a positive interest rate differential in relation to other countries, particularly in long-term rates, but also to the uncertainties that hung over the world economy from the summer of 1982 onwards and which induced inflows of funds to the United States. Between November and the end of the year the exchange rate declined considerably but it rose again in 1983 when the interest rate differential stabilized at a level that was still favourable to the United States and expectations of further reductions in US interest rates receded.

The real exchange rate of the dollar, which is calculated by correcting market exchange rates to take account of the relationship between the level of prices for manufactures in the United States and the average of those in competitor countries, was 5 per cent higher in March than it had been at the beginning of the seventies in spite of the pronounced decline that occurred until the closing months of 1978. The appreciation between the beginning of 1979 and March 1983 came to 28 per cent. Taking forecasts for the current year into account, it is estimated that in the three years from 1981 to 1983 the volume of US exports of manufactured goods fell by 25 per cent, whereas world markets grew by 2 per cent.

The United Kingdom has suffered a similar loss of export market share in the last five years as a result of the real appreciation of 63 per cent in sterling between the end of 1976 and the beginning of 1981; between February 1981 and March 1983 the real sterling exchange rate declined by 19 per cent. In March the real value of the yen was close to the level recorded at the beginning of the seventies; it underwent wide cyclical fluctuations during the period under review, appreciating by 30 per cent between the end of 1975 and mid-1978 and depreciating by a similar amount in the subsequent four years. The variations in the exchange rate of the Deutsche Mark were less pronounced, but substantial nonetheless.

The last ten years have seen a combination of economic shocks and policy changes that was bound to cause substantial shifts in equilibrium exchange rates. It would have been difficult to avoid using the flexibility provided by floating exchange rates as a means of alleviating the resultant pressures.

Nevertheless, the variations that have occurred seem excessive. Short-term volatility, with daily movements in the rates of the principal currencies not infrequently exceeding 1 per cent, introduces an element of uncertainty into international relations. More worrying still are the long-term shifts in real exchange rates and in particular the radical changes caused by anti-inflationary policies in the United States and the United Kingdom that hinge upon monetary policy. Such large changes impinge upon the allocation of resources through their effects on external trade, direct investment and the burden of international debt. In a highly interdependent world, investment decisions are hampered by the risk of arbitrary exchange rate movements that can distort the conditions for the profitability of plant. Protectionist tendencies are thus rekindled.

The reduction of inflation in the three major economies, and especially in the United States, is an important prerequisite for the restoration of a stable international monetary order. For exchange rate variations to be checked, however, it must be possible to count on consistency between monetary and fiscal policies. Coordinated interventions could then give more effective guidance to exchange markets by reducing exchange rate volatility.

Experience with the EMS supports these conclusions. The currencies linked together by the European exchange rate agreements have displayed relatively small fluctuations in both nominal and real terms. It has been seen, however, that the cohesion of the system can be safeguarded only when exchange rate changes are accompanied by a convergence of economic policies in the various countries. There have been delays in bringing about adjustment and serious tensions have developed, such as were evident at the time of the realignment in March of this year, but the discipline imposed by participation in the exchange rate agreement has strengthened convergence, thus dampening centrifugal forces that might have torn the entire European edifice apart.

The reintroduction of an international monetary standard that could serve as an instrument to reconcile external equilibrium and the recovery of world trade is a fundamental objective which must be pursued with the necessary gradualism. The Special Drawing Right could form the cornerstone of such a scheme. If this reserve asset is to play a central role, it must become the vehicle for IMF financing and lending operations. At the same time the creation of international liquidity through other channels must be curbed and its distribution controlled.

Interaction between the persistence of recession for a third year, the high level of real interest rates, the strength of the dollar and the deterioration in the terms of trade caused a rapid increase in the debt burden of developing countries and high-absorbing OPEC countries. The full gravity of the difficulties in the international payments field became apparent from the summer of 1982 onwards.

With hindsight, it is plain that too little attention was paid too late to the need for adjustment of these countries' economies and that the commercial banks were too ready to grant loans, often for purposes other than the expansion and modernization of industry. However, it was not easy to foresee that so many factors would conspire to exert a negative influence.

Export growth remained relatively high after the first oil crisis; in the five years from 1973 to 1977 the terms of trade of the developing countries improved at an annual average rate of 0.4 per cent, the same as in the preceding decade. In the five years that followed, however, they deteriorated by 3.4 per cent a year.

Between 1973 and 1979 average real interest rates were negative, thus contributing to the delay in adjustment. It should have been foreseen that interest rates would return to positive values, but from 1980 onwards the real cost of the developing countries' borrowing exceeded all reasonable expectations: the increase in nominal interest rates was accompanied by the decline in the dollar prices of their exports of primary products.

Oil imports by non-OPEC developing countries rose from $ 19 billion in 1978 to $ 39 billion in 1980, before declining to $ 30 billion in 1982. Interest payments increased from $ 20 billion in 1978 to $ 40 billion in 1980 and $ 60 billion last year. In the last three years their current account position has therefore shown a large deficit of between $ 75 and 95 billion.

The international indebtedness of this group of countries, which had totalled $ 340 billion at the end of 1978, exceeded $ 600 billion at the end of 1982, with more than half this amount being owed to banks. The three most heavily indebted countries saw the ratio of their total short-term debt and repayments of long-term debt to their exports of goods and services deteriorate by about 50 per cent on average in 1982 alone to stand at 100 per cent in the case of Mexico, 75 per cent in that of Brazil and 140 per cent in that of Argentina.

In these circumstances a slowdown in the flow of credit owing to more cautious lending policies, which were induced partly by the fall in the price of oil, was sufficient to trigger a rash of crises. The emergencies were tackled by means of a coordinated series of actions by international institutions, central banks and commercial banks.

The International ,Monetary Fund played a central role, negotiating loans conditional upon the introduction of adjustment programmes by the countries in difficulties. Substantial bridging facilities were arranged; some were granted by the US monetary authorities themselves and others by the principal central banks under the aegis of the Bank for International Settlements. The commercial banks were asked not to call in outstanding loans; this action, which involves mainly the exchange of information and coordination at international level, should not be taken to the point where it leads to an improper blurring of responsibilities between official institutions and private banks, whose functions are necessarily complementary.

The need to enable the International Monetary Fund to play a greater role in financing balance-of-payments deficits made it advisable to bring forward the eighth review of quotas, which will be raised from SDR 61 to

90 billion, to expand the finance available under the General Arrangements to Borrow from SDR 6.4 to 17 billion and to permit the latter to be used by countries not belonging to the Group of Ten in the event of balance-of-payments crises threatening the stability of the international financial system.

The problems of international indebtedness have been tackled, but their solution requires not only the implementation of adjustment programmes in the debtor countries but also a return to lasting growth in the world economy. In the present circumstances neither the developing countries nor those belonging to OPEC can help set the recovery in motion, which must spread and gain momentum in the industrialized countries. It is on the results achieved in promoting recovery and in the campaign against direct and indirect forms of protectionism that the ability to manage the risks of international financial instability will ultimately depend.

The main indicators suggest that the US economy has begun to recover; the changes that have been made in economic policy will allow this trend to gain strength, but the mix of fiscal and monetary policies is still such that it will have an adverse effect on longer-term prospects. The budget deficit is a factor in the continuing high real interest rates, particularly at medium term; this not only impedes investment but also perpetuates the inflow of capital, which bolsters the external value of the dollar.

Signs of a cyclical turnround are also emerging in Germany: the decline in interest rates and the expansion in the money supply give cause to view the German economy's capacity for recovery with a fair degree of confidence. In the United Kingdom cautious monetary and fiscal stimulus and the recovery in competitiveness should enable the British economy to come out of the prolonged recessionary phase. In Japan private consumption and residential construction are gaining strength. The decline in oil prices provides a significant boost for importing countries by reducing inflation and easing the balance-of-payments constraint.

Signs of impending recovery are therefore discernible in the countries with the best record in the fight against inflation and where it appears that pressures on the labour costs front will remain lower. Any tightening of economic policies that nipped recovery in the bud would have consequences which would be hard to control.

The world economy has drawn back from the brink of a crisis not dissimilar to that of the thirties, which led to the collapse of trade relations and to protectionism. The conditions now exist for a resumption of growth. The battle must be joined and won. Each and every country can and must contribute by taking coordinated decisions and actions appropriate to the state of its economy.

The Italian economy in the grips of inflation and recession

In 1982 Italy went through the bitter experience of recession in common with the rest of the world economy, but did not succeed in curbing inflation. The continued steep rise in prices and the persistent external deficit meant that a restrictive stance had to be maintained with regard to interest rates and lending. An acute conflict developed between the need for monetary stringency and the need to finance the public sector borrowing requirement.

At 79,600 billion lire, the borrowing requirement of the enlarged public sector exceeded the target set in the Forecasting and Planning Report by almost 30,000 billion lire and represented 16.9 per cent of gross domestic product, the highest ratio since the immediate post-war period.

The recessionary phase which began in mid-1980 became more acute in 1982, spreading to fixed investment and proving to be more protracted than the downturns experienced in previous cycles. Employment fell for the first time since 1972, with the services sector failing to make good all the job losses in agriculture and industry. Firms responded to the recession by putting surplus labour on the Wage Supplementation Fund and by virtually stopping recruitment altogether. Excluding workers covered by the Wage Supplementation Fund, unemployment passed the two million mark, or 9 per cent of the labour force. The deterioration continued in the first few months of 1983.

Despite the contraction in world trade, export volumes remained unchanged. Imports went up by 1.5 per cent as a result of the replenishment of stocks of raw materials, stimulated by low prices on international markets and, at the beginning of the year, by expectations of an impending recovery in demand, which in the event did not materialize. The trade deficit was kept down by the improvement in the terms of trade in the first half of the year, when the decline in raw material prices more than outweighed the stronger dollar; this trend came to halt in the second half of the year. The favourable performance of tourism offset the higher burden of interest payments on Italy's external debt. The current account deficit amounted to 7,400 billion lire, or 1.6 per cent of gross domestic product, as against 9,200 billion lire in 1981.

The current account deficit and the outflow of short-term capital occasioned by the reduction in banks' and commercial firms' indebtedness were financed by new foreign loans worth 8,800 billion lire and drawings on official reserves to the extent of 5,600 billion. At current exchange rates and excluding gold reserves, Italy's net financial position moved from a surplus of $11 billion at the end of 1979 to a deficit of approximately $ 21 billion at the end of 1982.

The rate of consumer price increase for the twelve months ending in December fell from 18.1 per cent in 1981 to 16.1 per cent in 1982. 'Wholesale prices turned in better results: whereas in 1981 their growth rate was close to that of consumer prices, in 1982 it fell to under 12 per cent. That the rate of consumer price increase was more reluctant to slow down is attributable to rises in public charges, administered prices and indirect taxation as well as to the fact that retailers' profit margins held up.

In the industrial sector increases in a number of social security contributions and the new arrangements for severance grants combined with the automatic support for wages afforded by the *scala mobile* to cause an average increase in hourly labour costs of 18 per cent in 1982, despite the absence of wage settlements. If productivity gains are taken into account, unit labour costs increased by 16.5 per cent.

The slowdown in the rate of growth of producer prices, from 17.8 per cent in 1981 to 13.5 per cent in 1982, was almost entirely due to external cost components, such as energy and raw material prices, the rate, of increase of which dropped from 33 to 11 per cent. As against this, the growth rate of domestic components, the most important of which is unit labour costs, went down from 18.9 to 16.1 per cent.

The inflation differential between Italy and the main industrial countries widened. Between the peak levels reached in the wake of the second oil crisis and March 1983 the twelve-month rate of consumer price growth fell from 14.6 to 3.6 per cent in the United States, from 8.7 to 2.3 per cent in Japan, from 6.8 to 3.5 per cent in the Federal Republic of Germany, from 14.3 to 9.0 per cent in France and from 22.6 to 4.6 per cent in the United Kingdom: in Italy it went down from 22.0 to 16.1 per cent.

The persistence of inflation in Italy has proximate causes and also deep roots in the past. The first increase in the price of oil hit an economy that was particularly dependent on this source of energy and already inflation-prone as a result of spiralling wages and institutional rigidities. It was followed by a further acceleration of wages and unit labour costs. The profound changes in the productive system required in the light of the changes in relative prices were hampered by insufficient labour mobility, by spreading and mounting indexation and by sectoral and regional disequilibria.

Consequently, the second oil shock came on top of inflationary factors which had not been eradicated in the previous years despite the stabilization measures that had been taken. Success in strengthening the industrial base in 1979-81, energy conservation, improved labour mobility and, recently, new budgetary measures, together with restrictive monetary policy, barely served to bring inflation down from the peak levels recorded in 1980 to the average for the decade from 1973 to 1982. These accomplishments failed to make serious inroads into the corpus of underlying causes, which took a firmer hold and became more tenacious as the years went by.

The combination of recession and inflation is not sufficient in itself to explain the extent to which the state borrowing requirement and exchange rate movements brought pressure to bear on the management of the money supply in the course of the year.

In the first few months of 1982 the slowing of price inflation and the beginnings of a decline in interest rates abroad enabled short-term rates to be manoeuvred cautiously downwards and the maturities of Treasury securities to be lengthened. This movement was interrupted by exchange rate pressures in March and April; in May normal conditions returned.

We gave an account of these events on this occasion last year. In remarking on the fall in inflation we intimated that further progress would hinge on the adoption of patterns of behaviour capable of correcting the forces that nurture inflation, and identified leapfrogging wages and prices and the public sector borrowing requirement as the chief threats to the domestic and external value of the lira. We also pointed out that the risk that the recovery of the world economy might be slow to appear could make the adoption of a more restrictive stance a matter of greater urgency. This assessment was borne out by subsequent events.

Strains within the European Monetary System culminated in the June realignment. In the talks on parities Italy stood by the line that it had maintained since the inception of the EMS, i.e. that the appreciation of the real exchange rate as a result of the faster momentum of prices and costs in relation to those in the other countries should not erode Italy's competitiveness to the extent that it undermined its industrial base, but that a policy of accommodation at odds with the objective of curbing inflation should be rejected.

The action taken in the summer stemmed from the recognition that the public sector borrowing requirement was diverging from the planned levels. Measures designed to bring in around 6,000 billion lire were taken in the fields of taxation, social security contributions and public charges.

These moves were also consonant with the need for a more fitting allocation of responsibilities as between monetary policy and fiscal policy in a period of falling inflation and declining industrial output. The downward movement in interest rates resumed after the break in the spring, induced by successive cuts in the tender rates of Treasury bills, which pushed yields on three-month bills to a low of 17.5 per cent in September.

In proposing a one-point cut in the discount rate in August — which had been constant at 19 per cent since March 1981 — the Banca d'Italia gave notice that the reduction in the cost of borrowing could be consolidated and extended to the whole structure of market rates only if the measures taken succeeded in keeping the Treasury borrowing requirement within the new targets.

In early autumn it was already becoming apparent that the effective deficit was exceeding the new estimates: even though the measures were beginning to bite, the monthly requirement was rising instead of falling. Further, the still unbroken link with the wage indexation mechanism caused the price impact of the tax and social security increases to have a ripple effect above and beyond their initial impact. At the same time the favourable shift in the terms of trade was petering out. Inflation rekindled: between July and November the average monthly change in wholesale and consumer prices worked out at 1.3 and 1.5 per cent respectively as against 0.6 and 1.0 per cent in the preceding five months.

The pressures made their appearance on the eve of a seasonally unfavourable period for the balance of payments. They were heightened by the imponderables associated with the negotiations on the wage indexation mechanism and by political difficulties, which delayed parliamentary approval of both the July measures and the finance bill and budget for 1983.

Soon thereafter the money and exchange markets were hit by acute difficulties.

The central bank had to take pressure off the exchange rate by clamping down on bank liquidity, and tackle the difficulties experienced in financing the public sector borrowing requirement. The situation would have called for a prompt increase in Treasury bill base rates at the tenders, allowing the State to tap liquidity direct from the market, which would have made it easier to counter the currency speculation.

Yet again, the pressure on the lira stemmed from leads and lags and the reduction in foreign currency borrowing with the banks. In October and November the official reserves fell by a total of 4,500 billion lire. As in the spring, the pressures were resisted. Control of bank liquidity — principally by means of repurchase agreements — was coupled with exchange measures: the requirement that 70 per cent of export credits of up to one year's maturity had to be financed in foreign currency was introduced in order to stabilize bank lending at the levels reached at the end of the summer.

The strains on the money market were more drawn out. The sheer scale of Treasury borrowing on the market, together with inadequate yields, spawned mounting anxiety and uncertainty. Statements about public debt and taxation of income from Treasury bills transformed these fears into a state of alarm. There was a real danger of a movement out of government securities.

Faced with the need to make payments, the Treasury got round the shortfall in market borrowing by overdrawing on its current account with the central bank beyond the permitted limit in September and, to a substantial extent, in all the remaining months of the year. The Banca d'Italia gave immediate notice of this state of affairs to the Treasury Minister as it is required to do by the law, which provides that payments must be suspended in the event that the overdraft is not brought inside the limit within 20 days of notification. At the height of the crisis the Bank made large purchases of securities at issue, raised yields on the secondary market to mop up liquidity and drew the Government's attention to the untenable situation that was developing. Treasury bill base rates were adjusted upwards slightly at the end of October and by a larger amount in mid-November, thus returning to the levels reached in March and close to long-term Treasury bond rates.

As a result of this action the difficulties on the money market were overcome — at the cost of overshooting the end-year objectives. In the event, the creation of monetary base via the Treasury amounted to 12,700 billion lire in 1982 as against the forecast made in June of 9,000 billion lire. The public's movement out of Treasury bills made for faster growth of bank deposits, which had already been expanding rapidly since mid-year.

Economic and financial policy programmes for 1982 had assumed that the public sector's domestic borrowing requirement would run at 43,000 billion lire and that domestic lending to the economy would expand by 30,000 billion lire. Midway through the year the public sector borrowing requirement was lifted to 61,000 billion lire; the final figure for the year was 67,900 billion. Lending to the economy grew by 30,100 billion lire.

Public sector borrowing came to 27.6 per cent of outstanding debt, as against the initial forecast of 17.5 per cent, while lending to the economy, at 14.0 per cent, was on target. Total domestic credit expansion reached 21.0 per cent; as a percentage of gross domestic product it rose from 18.1 to 21.4 per cent between 1981 and 1982.

Restrictive action by the Bank — in the shape of the regulation of monetary base and direct controls — was directed towards limiting borrowing and increasing the propensity to save by allowing real interest rates to rise.

The rate of growth of total lending to the economy fell from 18.2 per cent in 1981 to 14.9 per cent in 1982. The real cost of bank credit — calculated by deflating the average lending rate for wholesale price changes — worked out at 8.1 per cent, 3.4 points up on 1981. Industrial firms paid an average real rate of 6.5 per cent on total credit granted in 1982.

Under the pressure of the public sector borrowing requirement, financial assets held by the economy expanded by 20.0 per cent, two points more than in 1981. Compared with the recent past, the composition of flows shifted away from Treasury bills to bank deposits and securities with maturities of more than one year. Corrected for changes in consumer prices, the yield on financial savings increased by an average of four points in the course of the year, albeit remaining negative. Net of the inflation-induced loss of purchasing power, households invested 2.8 per cent of their disposable income in financial assets, as against 0.3 per cent in 1981.

The flow of 30,000 billion lire earmarked for lending to the economy when the forecasts for financial flows were made, was viewed by the Bank as restrictive, and it was in fact so low that it was not possible to offset even part of the higher public sector borrowing requirement by further restricting lending to the corporate sector. Had this been done it would have pushed up the cost of borrowing to intolerable levels, which would have had grave effects on production and investment. To have offset this difference in full would have entailed cutting lending to the economy by 83 per cent last year. Ten years ago, when the public sector borrowing requirement amounted to 34 per cent of total domestic credit — as against 68 per cent today — offsetting a percentage difference of the level recorded this year would have necessitated pruning lending to the economy by 30 per cent.

At the beginning of the new year the technical and institutional problems posed by the excessive overdrawing on the Treasury's current account were overcome — but certainly not the economic and monetary ones — by Parliament's approval of an extraordinary advance to the Treasury. Action to curb deposits and bank lending was stepped up as a result of the measures taken by the Interministerial Committee for Credit and Savings and the Banca d'Italia in December. The changes made to the compulsory reserve system sought to slow down the expansion of deposits, to make operations economically tantamount to bank deposit-taking subject to the same rules and to increase the effectiveness of indirect methods of monetary control.

The acceleration recorded by the monetary aggregates at the end of 1982 was gradually corrected in the first few months of 1983. The public increased its preference for longer-term securities, making a significant investment in Treasury credit certificates. There was a break in the process of reintermediation by the banks.

On the exchange market the lira — helped to some extent by the interest rate differential — remained stable in the upper part of the EMS fluctuation band throughout the winter until early March, although from early February onwards approaching elections in France and the Federal Republic of Germany, on top of the divergent performance of the European economies, created expectations of a realignment and concomitant strains within the European Monetary System.

When the lira was caught up in the crisis, the Bank reacted by curbing bank liquidity, raising very short-term interest rates and allowing the exchange rate to find its own level in order to discourage moves prompted by the delay in carrying out the realignment, which was now inevitable.

Following the realignment of central rates on 21 March the lira settled at values slightly above those that it had attained in the two preceding weeks. The reserves used to defend the exchange rate were quickly recouped. Liquidity returned to normal and interest rates were able to resume their downward path, assisted in early April by a one-point cut in the official discount rate.

These tactical successes — accomplished by keeping the exchange rate and liquidity under control — do not resolve the fundamental problems. As a result of the recent realignment and the prevalence of stabilization policies in the other countries, Italy is in danger of remaining the only EMS country out of step, the only one in which the fundamental corrections have still to be taken in hand.

Public finance and monetary policy

In an economy suffering from high unemployment and needful of changes in the industrial fabric, budgetary policy can help to alleviate the existing disequilibria and stimulate capital formation in appropriate directions. In Italy this vital role is hampered by the sheer size of the deficit and by the characteristics which expenditure policy has acquired in the course of time, which influence the economy in ways incompatible with the external constraint and price stability. The events of 1982 underscore the extent to which this has conditioned monetary policy.

The efficiency and controllability of expenditure have been affected by institutional changes that have divorced responsibility for decision-making from responsibility for financing the measures, increased the degree of indexation of expenditure, indiscriminately expanded the social security system and ignored demographic trends. The forms and dimensions that state aid to households and firms has acquired disregard the need for compatibility between resources and the calls upon them. Government expenditure has generated demand without significantly improving supply conditions. The standard of public services has widened the gulf between the trend of labour costs and that of productivity in the economy as a whole.

The strength of these causes of fundamental disequilibrium is borne out by the size of the 1982 borrowing requirement and that forecast for the current year, despite the extensive corrections that have been made, particularly on the receipts side, and which should produce improvements equal to 6 per cent of gross domestic product in 1983.

The rapid growth in many components of expenditure will soon begin to raise even greater problems. In particular, demographic trends, the gathering momentum of the pension schemes and the tendency for the scope and cost of health services to increase will enlarge the deficit and raise the pressure on financial resources.

The population of pensionable age will increase rapidly and will exceed the present level by about 1 million at the end of this decade; the ratio of this group to the population of working age over 20, which will itself grow by almost the same number, will rise to 45 per cent in 1991, after having increased from 40 to 42 per cent between 1971 and 1981.

For a family, a firm or a community, the budget constraint is another way of saying that the satisfaction of needs depends upon the resources that are available or can be generated. Openness to foreign trade and the countercyclical function of public spending make higher levels of prosperity possible, but they do not remove the budget constraint. If economic agents formulate their behaviour on the assumption of a volume of resources that is not and will not be available, the inevitable restoration of real equilibrium will be all the more painful the less it is the result of a conscious choice; if the return to equilibrium occurs by monetary means, economic performance and patterns of economic behaviour will be modified by shifts in the exchange rate, the level of prices and interest rates, each of which reflects the value of the currency from a different angle.

In 1981 and 1982 gross domestic product remained unchanged; the public sector, on the other hand, increased its borrowing by 14 per cent in real terms and the country's external debt went up by $ 9 billion.

The ratio of taxation to GDP rose by some 2.5 percentage points in 1982 and is expected to increase by a further 3 points in 1983 to 42 per cent. In view of the temporary nature of some of the measures that have been taken, major action will be needed in this area just to keep the ratio at this level. In order to avoid further stimuli to inflation, the planned increase in indirect taxation will have to be coupled with changes in the indexation arrangements in accordance with the procedures, embodied in the agreement on the cost of labour.

The long-term trend of the government deficit cannot be reversed by continually increasing the tax burden, even though more radical steps have to be taken to deal with tax evasion.

The expenditure problem will have to be tackled by making a course correction. We have mentioned certain aspects of the pension and health systems because of their size and the nature of the mechanisms that operate within them, but the choices that must be made apply equally to the entire range of public expenditure. The progress that has been achieved in the social security field as a result of greater prosperity and a stronger feeling of solidarity can be protected and perpetuated only if there is true fairness in the distribution of income, monetary stability and efficiency.

Certain technical and economic criteria should be emphasized. First, a clear distinction should be drawn between public goods and services offered in accordance with the efficient allocation of resources, and welfare payments granted on the basis of social justice and solidarity. Secondly, the types of public goods and services offered and the level of provision should accord with the aim of balancing benefits against costs in terms of the overall utilization of resources. The third criterion is that eligibility for welfare payments should be determined on the basis of actual need in order to ensure greater fairness and to prevent the indiscriminate provision of subsidies which, because of their low unit value and the large number of claimants, are inadequate for recipients and yet burdensome for the community.

Improved efficiency in the provision of public services and revision of the indexation mechanisms, which accentuate the unchecked expansion in outlays, are essential if a more correct stance in terms of the principles involved is to be translated into better control over expenditure.

The problems described above are common to the majority of industrial countries, but in Italy they have taken on larger proportions and there has been delay in taking corrective measures. Over the last five years the general government deficit has averaged more than 10 per cent of gross domestic product, whereas in the other six major industrial countries it has ranged from 1 per cent in the United States to 4.5 per cent in Japan. The gap is smaller, but still substantial, if interest payments are excluded.

If corrective action is not taken, the task of monetary policy will become extremely arduous. The monetary authorities would be failing in their duty if preoccupation with minimizing the cost of public and private borrowing led them to accept the monetization of the debt and to acquiesce in inflation and a flight from money. In order to prevent this, monetary policy should keep interest rates sufficiently high to encourage saving. However, in times of stagnation or slow growth, positive real interest rates can outstrip the rate of growth of the economy and prove unsustainable over the long term because they give entitlement to an income that the economy does not in fact produce.

In the recent past the payment of positive real yields on government securities has averted the danger of financial assets being dissipated in higher inflation as a result of attempts to use them for consumption or the purchase of hedge goods. Monetary policy has thus avoided a vicious circle involving mounting debt, inflation, external deficits and the exchange rate. But these remedies cannot cure the fundamental disequilibria.

An economy has no built-in safeguards against the danger that inflation will rise to ever higher levels, particularly after monetary depreciation has been rooted in expectations and behaviour for more than a decade. The fact that this danger has been averted once does not mean that it has been banished for all time. Daring manoeuvres to bring down interest rates would be steps towards the disintegration of the currency.

The corporate sector, which in past years benefited from the subsidy implicit in negative real interest rates, is smarting under the high cost of money and has expressed its discomfort in no uncertain terms. However, if we are to be consistent in our rejection of inflation, a decrease in interest rates should be strictly conditional on a decrease in inflation. This is the line we have followed in the past and are still following today. The gradual reduction in the cost of money has not been helped by the attacks on the lira, which were launched and repulsed twice in 1982 and which twice caused the downward movement in interest rates to be suspended.

The Government's decision to place the matter of the Treasury's excessive overdrafts on its current .account with the central bank before Parliament by requesting an extraordinary advance was the institutionally proper course of action. By this means the representatives of the community at large were made aware of the serious imbalance between the amount of funds to be disbursed and the amount of funds actually available. Had the central bank chosen to conceal this problem by purchasing sufficient securities to bring the overdraft back within the legal limit, it would have violated the spirit of the rules governing its conduct. The limit on the Treasury overdraft is not a mere technicality, it is a necessary condition for a policy of monetary stability and is rooted in the constitutional principle that savings must be protected. The discretionary powers vested in the Banca d'Italia may not be used to betray this principle.

The extraordinary advance enabled Parliament to avoid the trauma of the suspension of payments. The fact that the advance was for a fixed term commits the Legislature itself and the Executive to making the budgetary aggregates consistent with a tight monetary stance.

For stable and predictable monetary conditions to return, society itself must make fundamental choices: no technique or instrument of monetary control can stand in their stead or indeed induce them. However, this does not detract from the importance of seeking and perfecting methods of credit control and market intervention that are valid now but also go beyond the needs of the moment.

Starting with the reforms made to the compulsory reserve system and to the Treasury bill tender in 1975, the measures taken in recent years have resulted in increased operations on the open market in conditions in which the professional skills of the intermediaries are fully utilized and developed, the flow of information to the public is increased and competition strengthened. The Treasury bill market has been made accessible to a greater number of participants and its operational structure reinforced so that it has become the main forum for the control of monetary base and liquidity, even though the burgeoning public sector borrowing requirement and the persistence of inflation have caused it to expand to such an extent as to complicate this exercise. Monthly issues of Treasury bills climbed from 2,780 billion lire in 1975 to 22,800 billion in 1982 gross and from 870 to 2,800 billion lire net. The fact that bank liquidity — the operationally significant aggregate in the very short term — increased from 2,350 to 3,350 billion lire in the same period brings out the increased delicacy of the mechanics of monetary base control and the extent to which access to adequate techniques and mobility of short-term interest rates is necessary in order for it to operate effectively. The measures taken more recently are consistent with and strengthen this approach.

The need to reduce fluctuations in liquidity led to the introduction of fortnightly tenders on the new issues market and to the development of repurchase agreements on the secondary market. By virtue of their flexibility the latter have proved to be an efficient instrument for the day-to-day regulation of monetary base; they are a useful means of maintaining orderly market conditions in the presence of high and variable Treasury payments flows as well as facilitating the successful outcome of Treasury bill tenders, and enable vigorous restrictive action to be taken when special circumstances so require.

The introduction of competitive tenders for three-month Treasury bills, which are still open only to credit institutions, constitutes a further step in the delicate operation of reconciling the requirements of monetary control with the Treasury's need to procure funds in the market on the best terms.

The increased ability to regulate monetary base afforded by these innovations is complemented by the changes made to the compulsory reserve system last December, which link the monetary base more efficiently to the level of bank intermediation. The reserve ratio was increased, which had the effect of reducing and stabilizing the deposit multiplier. The Interministerial Committee for Credit and Savings further resolved that the ratio could be changed, within specific limits, by the Treasury Minister at the proposal of the Banca d'Italia. Finally, it decided that the system should converge towards a single stock-based ratio, thus speeding up the existing trend towards a reduction in the differential impact of the reserve requirement on the various credit institutions; this will ensure that changes in the reserve requirement will have unequivocal effects on monetary expansion irrespective of whether deposits are increasing or decreasing.

The introduction of forms of negotiable bank deposits with less marked monetary characteristics, such as certificates of deposit, which was encouraged by the payment of a higher rate of interest on the corresponding portion of compulsory reserves, makes for greater transparency and hence for enhanced protection of savers, stimulates the proper exercise of competition and in time should result in a closer link between money-market rates and bank lending rates.

The choice of intervention techniques and instruments calls for a sense of pragmatism and heed for the long-term implications. Methods of indirect control avoid the inefficiencies entailed by applying a uniform yardstick to a system which is simply not uniform. Administrative credit controls can be useful in order to obtain a swift and more precise impact on the expansion of lending; we have repeatedly had recourse to such measures.

The lapsing of the ceiling on bank lending at the end of June 1983 in accordance with, the intention expressed last December stems partly from the conviction that prolonged usage has reduced its effectiveness and is taking its toll of the economy. The degree of credit restraint and the instruments used to achieve it are separate issues. The transitional period will be facilitated by responsible behaviour on the part of banks, large and small; the necessary precautions will be taken.

Guidelines for the financial system

The disparity between the financial balances of the three main domestic sectors that are final users of resources was again extremely large in 1982. In relation to gross domestic product, the net borrowing of the public sector and the corporate sector amounted to 13.9 and 3.1 per cent respectively, while households' net financial saving was 15.3 per cent. The capital market and especially the credit intermediaries had to cope with a correspondingly large flow of funds in difficult conditions.

Criticisms were levelled against the banking system that may have given the impression that firms' difficulties are basically of a financial nature and that industrial growth could be revived merely by eliminating certain inefficiencies in intermediation. Analysis of banking costs presents difficulties both in theory and in practice. The Banca d'Italia has carried out research with a view to supplying objective data and helping bankers improve their performance through a better understanding of the system; the findings of this research are to be published shortly.

The least unsatisfactory indicators of how much the banking industry costs the economy are the difference between total interest received and paid (the interest margin) and the sum of this balance and net income from banking services (the gross earnings margin), related in both cases to a measure of the volume of business.

According to a comparative OECD study for the year 1977, the margins of the Italian banking system were in the middle of the range for the OECD countries. A fresh analysis has subsequently been carried out for

1977-81 using basically the same methodology but differentiating between classes of banks and covering a smaller number of countries.

The most meaningful comparison is that of the interest margins of commercial banks, since their operations are broadly similar in the various countries concerned. The Italian banks were also found to be close to the median during the five-year period, with an interest margin of 2.8 per cent of balance sheet assets. The lowest margin, 2.1 per cent, was recorded by the German commercial banks. If gross earnings margins and the other categories of banks are considered, the values recorded by the Italian banking system tend to rise.

International comparison thus shows that there is scope for reducing banks' margins, but it also reveals the limits to such action. Achievement of this objective, which certainly cannot be brought about by fiat, is the contribution of greater efficiency the banking system is required to make, together with an improvement in the quality of its services. Nonetheless, there is no hiding the fact that the effect on interest rates will necessarily be small in relation to their present level.

If real progress is to be made in bringing down the cost of money, conditions permitting a less restrictive monetary policy will have to be created. The decline in rates started as soon as the imbalances in the economy showed signs of diminishing. From a peak of 25.4 per cent at the beginning of 1982 the average rate on overdrafts declined to 23.7 per cent in April of this year. Over the same period the prime rate decreased by three points to 18.75 per cent.

The interest rate problem, however, must not distract attention from the real as opposed to the financial difficulties of many large firms. Their heavy reliance on loan capital reflects their inadequate self-financing capacity or even losses. The balance sheets of the leading companies show that in 1975-81 not even gross operating profits would have been enough to cover depreciation that took full account of the useful life and replacement cost of capital goods. It follows that the anaemic profit and loss accounts of many sectors are due to the serious imbalance that has developed between prices and non-financial costs.

Progress in getting the economy back on to a sound footing will push interest rates down not only directly but also by reducing the cyclical component of banks' gross earnings. In recent years the commitment to fight inflation, coupled in some cases with the external constraint, has led the major countries to maintain a restrictive monetary policy stance even after economic activity has turned down: because lending rates rise faster than deposit rates, the pro-cyclical nature of banks' margins has been accentuated.

A no less important aspect of banking, especially in an economy engaged in a large-scale reallocation of resources, is the ability to assess creditworthiness.

Experience and banking practice supply general criteria, based on the interaction between production and finance, that make full use of the scope for the responsible exercise of discretion and prevent this from degenerating into arbitrariness. By drawing attention to these criteria in last year's Concluding Remarks and then carrying out a study both in Italy and abroad, we sought to stimulate and strengthen the commitment to apply them in the most appropriate manner.

Prudence and independence in the selection of borrowers safeguards both the soundness and the allocative efficiency of the banking system. The stagnation of the economy was bound to be reflected in bank lending. The credit system did not shirk the task of supporting firms and thus enabled them to make vital investment in reorganization.

The proportion of bad debts increased in every sector. Banks looked for ways of reducing or offsetting the marginal risk attaching to loans. The data collected by the Central Risks Office show that banks tended to prefer customers in sectors, geographical locations and size categories with a better-than-average record of bad debt. In addition, gross profits were used to increase provisions and depreciation. The Italian banks' own funds thus approached the levels obtaining in countries where banks can more readily strengthen their capital base through share issues.

In its role as supervisory authority the Banca d'Italia has analyzed the determinants of competition to discover the means of achieving lasting improvements in the efficiency of the banking system. It has sought to achieve stability by encouraging banks to diversify their risks and strengthen their capital base and by maintaining orderly conditions in the capital markets. Faced with the spread of erroneous views of the role of the credit system as a result of the difficulties in the economy and certain events in the banking sector, the intrinsically entrepreneurial nature of banking was reaffirmed through the organizational changes made in public sector banks, the new regulatory framework for medium and long-term credit institutions, the proposals for new legislation on the control of bank ownership, banks' shareholdings in other companies and the separation of lending from the granting of incentives.

It was made easier for foreign banks to set up in Italy. Authorizations to open or transfer branches and to acquire controlling interests in other banks made inroads into local oligopolies. The stimulus to competition was also heightened by strengthening the money market.

The supervisory authority sought to resolve the potential conflict between economies of scale and competition by avoiding excessive concentration, fostering rationalization rather than expansion of the branch network, encouraging an increase in the average size of the smaller banks engaged in domestic deposit-taking and lending, and entrusting the major banks with the most demanding forms of international banking business.

To have left large parts of the banking system to perform a purely deposit-taking function would have conflicted not only with the requirement for competition but also with that of satisfying credit demand from deserving small and medium-sized firms. The savings banks have been working for some time now to achieve a better balance between deposit-taking and lending. The completion of this process is in the hands of the individual banks; proposals have been made, and in several cases implemented, for changes in company statutes to permit the public to supply minority capital and entrepreneurial ability; the range of savings banks' operations has been extended and encouragement given to the search for ways of achieving more efficient size, including voluntary mergers.

The need to re-establish the distinction between the political and business spheres also applies in the banking field, especially in connection with appointments to governing organs. Since the key aspect of banking is the granting of loans in accordance with economic criteria, the professional ability of the governing organs must be used to the best possible advantage by excluding partiality. Above all, managing directors and general managers must be chosen among bankers with no "labels" who have passed the test of a long career in banking or business management.

Partly as a result of supervisory regulations, bank balance sheets already go beyond the minimum requirements of the Civil Code and are normally more detailed than those of Italian non-banking firms and banks abroad. A study is nonetheless to be conducted of ways of increasing the flow of information from banks, including the publication of interim accounts. The value of the information would be increased if the law were changed to allow more consolidation of accounts. An equally important objective is the transparency of the terms and prices of banking services. Competition and disclosure of information, which should not be confused with the confidential returns submitted to the supervisory authority, do not detract from the stability of the financial system; on the contrary, they reinforce it.

Supervision must continue to be based on discretion both in general and in individual cases. It would be facilitated if authorization procedures were simplified, as in the case of the amendments made, under Law No. 23 of 1981, to the rules governing lending by special credit institutions in excess of their limits. However, the effectiveness of controls also presupposes that other bodies, first and foremost bank boards themselves, accept a full share of responsibility and requires a more structured definition of some international aspects of supervision. The new Basle Concordat, which was recently concluded, is intended to strengthen the coordination needed to prevent banks or banking establishments slipping through the supervisory net.

The failure of Banco Ambrosiano highlighted the gravity and dangerousness of the disorders that develop when fraudulent behaviour manages to insinuate itself into banking behind a screen of ordinary operations, with the connivance of third parties. The intervention of the supervisory authority brought to light abnormalities that dramatic events have shown to extend well beyond the world of banking. It subsequently took steps to remedy the repercussions on the bank itself using the instruments available under the present regulations; in so doing it had to strike a balance between the need to determine the scale of the failure and where the responsibility lay and the need to limit its impact on the stability of the banking system as a whole.

The Banca d'Italia's adoption of a new stance towards banks' activities abroad dates back several years and was embodied in the regulations laid down in the January 1981 resolution of the Interministerial Committee for Credit and Savings. This confirmed the policy of not allowing indirect shareholdings, set in motion the dismantling of the holding companies upon which many Italian banks had based their networks of foreign subsidiaries and made it possible to introduce regular returns, some of them on a consolidated basis, on the main aggregates of subsidiaries' accounts. The direct ownership of foreign subsidiaries is designed to eliminate the difficulties that intermediate holding companies create for supervision. A parallel policy is that of requiring banks to divest themselves of their holdings, in whatever form, in companies located in countries whose systems of control either do not appear adequate or do not allow sufficient information to be made available to the parent bank's supervisory authority. The banks concerned have taken the decision to dismantle their holding companies or are about to do so. Many banks have already sold off some participations, reduced other shareholdings and revised their subsidiaries' statutes as part of a process that they are required to complete as rapidly as possible.

Legislation and supervision will have a greater impact on the efficiency and soundness of banks if they are complemented by expansion of the share market. This is also a condition for resolving the perennial problem of imbalance in the capital structure of firms.

Looking back at the diagnoses and proposals made in past years, one finds that many of the legal and institutional conditions then considered desirable have now been created, the most recent being the possibility of setting up unit trusts.

The development of merchant banking activities would help medium-sized firms grow bigger and stronger and would pave the way towards stock exchange listing. Looking to the future, these activities could usefully complement the operations of unit trusts and increase their investment opportunities. If new structures were required to achieve this, flexible and effective forms could be promoted jointly by the banks without precluding participation by other parties. The object of these companies should accord with investment in bonds and shares issued by private and public sector companies on the basis of the risk and yield of the portfolio as a whole; they should be formally prohibited from acting as holding companies with *a priori* preferences about the firms to be financed. Shareholdings in the new companies should be related to the own funds of each participant, just as both the shareholdings and the borrowings of these companies should be related to their own funds.

Finally, it is worth re-examining the experience gained with Law No. 787 of 1978 from the points of view of the techniques employed and the underlying principles; this law provided practical means for setting up banking consortia that would meet the capital needs of firms in temporary financial difficulties.

On its own, the institutional framework cannot change propensities or patterns of behaviour. This can be done by markets, however, when they are backed by a banking system that realizes their role not only competes with but also complements its own intermediation and when they allow the basic determinants of share prices to prevail, thus encouraging firms to issue equity capital that savers wish to purchase.

The choices for stable recovery

The world economy is emerging from the longest recession since the second world war. There are doubts about the duration of the recovery and hence about the scale of the effects that it will have on world trade. As far as Italy is concerned, the question to be asked is to what extent and in what conditions exports can benefit from the upturn and stimulate balanced growth.

The impending recovery in the international economy will find Italy with a productive system that is profoundly changed compared with the beginning of the seventies. The 1981 Census shows the change to have been even larger and more extensive than previously realized. It affected the geographical distribution of production, its organization and the relationships between sectors.

The gap between the industrial triangle and the rest of the country was narrowed by the rapid growth of the eastern regions in the north and centre and by the emergence of new economic conditions in large parts of the Mezzogiorno. The importance of agriculture declined. This was due less to workers leaving the land than to old agricultural and craft economies turning to industrial activities, to which they have brought solid traditions and stable social relationships.

The larger role of the services sector came not only from the growth in consumer services but also from the greater complementarity of industry and services and new forms of specialization. Functions that were previously carried out internally, such as accounting, financial management and research, are being separated from the production side.

The industrial fabric has been transformed both by changes in the existing structure and by the setting-up of factories based on new criteria. Partly to escape from the increasing rigidities deriving from the legal and social environment, manufacturing industry moved away from plants geared to the mass production of a small number of goods towards smaller units specializing in individual phases of the production process. In engineering and the motor industry, where 40 per cent of manufacturing employment is concentrated, small and medium-sized factories established themselves in a strong position: more recently, some large factories have also been modernized with the introduction of multi-purpose machines and the automation of parts of the manufacturing process.

The new picture shows a production system which, in certain important respects, is able to adapt and react to market developments. However, dynamism and innovation have been evident mainly in the so-called mature sectors; there has been less initiative in those making advanced-technology products. Alongside the new firms and those with modernized organizations and production techniques there are still firms and groups, especially among those operating in the public sector and in basic industries, that have made little progress in curing their ills.

The cyclical course of the Italian economy in the wake of the second oil crisis has been characterized by sustained high levels of domestic demand compared with other countries. At the end of 1982 demand was 3.3 per cent above the average for 1979: over the same period it rose by 4.7 per cent in France and by 0.5 per cent in the United States and fell by 1.2 per cent in the United Kingdom and by 4.3 per cent in Germany. The deficit on Italy's external accounts over the last three years was the largest recorded by a major industrial country.

Elsewhere the long recession has provided an opportunity and a stimulus to curb domestic costs and reduce the share of saving absorbed by the public sector. According to OECD calculations of the cyclically adjusted ratio of public sector balances to GDP, in the period 1980-82 every major industrial country apart from the United States and Italy (which already had the largest deficit) recorded a smaller deficit or a larger surplus. In the same period, Italian money wages continued to rise at a rate that was incompatible with bringing inflation close to the levels obtained in the other industrial countries. Moreover, the narrowing of wage differentials has increased wage pressures and caused distortions in the allocation of labour. Real hourly earnings in industry rose by an annual 1.8 per cent in Italy and France, whereas they dropped by 1.4 per cent in the United States and by 1.3 per cent in the United Kingdom and remained stable in Germany.

The latest data portray an economy still in the grips of recession, with public finances in serious imbalance and with costs and prices beset by undiminished tensions.

In the first quarter of 1983 industrial production fell below the levels recorded at the close of 1982 and in January the unemployment rate reached 9.8 per cent. Economic forecasts and business surveys indicate an improvement in production prospects in the coming months fuelled both by exports and by demand for non-durable consumer goods. Wage settlements in the public and private sectors, tax reliefs and other government expenditure will have an expansionary effect on households' disposable income.

As regards public finances, primarily owing to the postponement of some corrective measures and the failure to approve others, the borrowing requirement threatens to overshoot the Government's target for the third year running. In 1984, even if the intention of keeping the tax to GDP ratio unchanged is achieved, expenditure will tend to raise the state sector borrowing requirement as a percentage of GDP above the level planned for 1983. This is a tendency that delays instead of advancing the adjustment of the economy; its correction will require other interventions.

The doubling of the borrowing requirement in the space of two years produced a rapid increase in financial assets. In relation to GDP they rose from 108 per cent at the close of 1980 to 113 per cent at the end of 1982 and the forecast is that the ratio will rise by as much again in 1983 to reach the highest value for the last ten years.

In the first three months of 1983 wholesale prices slowed down considerably to an average monthly rate of increase of 0.4 per cent; consumer prices rose at an average rate of 1.1 per cent in the first five months of the year. As in 1982, the deceleration of producer prices forecast for 1983 as a whole is attributable to the slowdown in the external cost components, such as energy and raw material prices; this could be brought to a halt by world recovery. The domestic components continue to rise rapidly: the wage agreements signed so far, the implementation of the changes in the legislation on severance payments and the effects of the indexation mechanism do not presage a significant reduction in the rate of increase in labour costs per worker in 1983.

Coming at a difficult juncture for industrial relations, the agreement of 22 January averted a deterioration in the labour climate, but if it is to prove a turning point, it must not be allowed to remain an isolated event. In the agreement the two sides of industry reduced the coverage provided by wage indexation and established the principle that their decisions and behaviour would be constrained by predetermined rates of consumer price inflation. This principle must be applied rigorously with a view to achieving a rapid reduction in inflation.

If a premature recovery in consumption generated by the public sector deficit and by the growth in money incomes were to come on top of the expected stimulus from exports, the fight against inflation would become arduous. Imports of finished products and raw materials would surge and nullify the good results of exports and tourism; the current account, which is moving into balance, would swing back into substantial deficit. The additional costs deriving from wage settlements would be coupled with fewer scruples about restoring profit margins through price increases. There would be a risk that the small progress laboriously made on the road to stability since the second oil crisis would be rapidly annulled.

The burden of holding inflation under control would once again fall on monetary policy alone and the incipient recovery would be stifled.

Ladies and Gentlemen,

The capacity to save, the availability of labour and the existence of unmet social and private needs are features of an economy that fulfills the basic conditions for embarking on a growth path which will increase households' prosperity and improve the outlook for the employment of young people. While continuing to exhibit proof of its vitality, the Italian economy nevertheless suffers from rigidities and fragmentation and from a pattern of savings utilization and a cost structure that prevent it from realizing its growth potential.

High inflation, not scarcity of resources, is the real barrier to sustained growth.

The reason why inflation has not been checked in Italy in the way that it has been in the major industrial countries is that Italian society has failed to show real determination in tackling it. The economies successful in curbing inflation, which are now seeing prospects of recovery open up as a result, have had to make bold choices, adopt tenacious policies and accept costs and sacrifices.

In Italy limited time frames have precluded even the definition of a long-term anti-inflationary policy. Even more importantly, the tendency in Italy has been to regard inflation as a minor ill with no bearing on growth or employment or even as being their natural accompaniment; or to consider that inflation will burn itself out on its own, even though it has to be admitted that the fires of inflation have been burning for more than a decade. There has been insufficient understanding of the causes of inflation and of the damage it occasions. It has not been fully realized the extent to which inflation has been implanted and nurtured by external factors — ranging from the cost of energy sources to the abandonment of fixed exchange rates and the fading-away of an international monetary standard — and domestic factors, such as indexation and the widespread tendency to look to the State to provide. The idea has even taken root that it is possible to live with inflation, provided something is done from time to time to keep it in check, or, alternatively, that groups and individuals can protect themselves by offloading the damage onto others.

There is no other explanation for the out-and-out defence of mechanisms and patterns of behaviour that can only cause nominal incomes and prices to rise in step, when the same real incomes could have been obtained through consensus policies designed to keep both inflation and money incomes under control.

Nor is there any other explanation for the willingness to introduce public intervention systems involving budgetary outlays that — now and to an even greater extent in the future — are at odds with the most sanguine growth forecasts and promise to distribute income that has not been produced, indeed shows no likelihood of being produced, at least in the short term.

Two years ago on this occasion I analyzed the causes of the spread of inflation within the Italian economy and spoke of the dangers of a breakdown in industrial relations and of the very fabric of society inherent in the continued debasement of the monetary yardstick. My reference to the need for a monetary constitution could have been taken as abstract, as advocating Utopia. It was not a mere cry of alarm: it was intended and is intended today to be a plea for a return to reality, to reaffirm that there can only be growth and orderly life in society if the currency is stable, and to indicate principles and methods consonant herewith. The currency cannot be restored to soundness by technical means or by financial tinkering. Anyone who thinks that the system can remain for long in a state of precarious equilibrium waiting for external events to lift us off the shoals is deluding himself. Events abroad can assist us, provided our own efforts are such that we can take advantage of them. Failing this, the events themselves will distance us from the international community.

Italian society must choose: it must either bring sense to bear upon the restoration of economic equilibrium and thus become the instrument of its own salvation, or continue to carry the growing cost of adjustment brought about through the inequitable redistribution of wealth and the waste of resources. There can be no half measures: acts of will are required.

Restoration of a stable currency necessitates changes in behaviour patterns and in institutional arrangements on two fronts: that of the public sector deficit and that of wages and salaries.

Respect for the budgetary constraint must be re-established at all levels of public finance. Today the constitutional requirement for expenditure decisions to be matched by provisions to raise revenue has become nugatory. This constraint, as we have repeatedly stressed, must be enforced with the objective of balancing current receipts and expenditure within a given time span. The same principles should also apply at local level: the aim of improving the efficiency of public spending by administrative decentralization will be thwarted in the absence of the discipline that can only be imposed by an awareness that financial resources are finite.

Dialogue between the two sides of industry is essential to sustain a healthy democracy. Agreements aimed at breaking the wage/price spiral are by no means incompatible with confrontation between workers and employers; indeed, they demonstrate the validity of that confrontation. The spirit of January's agreement on the cost of labour should not be allowed to die. Re-establishing price stability on the basis of wage stability does not call into question the distribution of income but reaffirms the central place of labour in production and trade.

These are the conditions that would enable monetary policy to sustain a growth path that realizes the economy's potential. These are the requirements that must be met if Italy is to continue to be linked, in conditions of monetary stability, to the countries with kindred economic systems, cultures and civil institutions.