BANCA D'ITALIA

ABRIDGED VERSION OF THE

REPORT

FOR THE YEAR

1983

PRESENTED BY THE GOVERNOR TO THE

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1984

THE GOVERNOR'S CONCLUDING REMARKS

ROME
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THE GOVERNOR'S CONCLUDING REMARKS

The Report presented to you today embodies a number of innovations; the descriptive sections of the text have been slimmed down, partly in view of the publication of the Bank's Economic Bulletin, and attention has been focussed on the analysis of specific issues, while the Stadstical Appendix has been reorganized so that it constitutes not only a supplement to the body of the Report but also a more systematic collection of data on the Italian and world economies. By publishing statistics, research papers, analyses of economic events and commentaries on economic policy, the Bank gives account of its own actions and fulfils its obligation to emphasize the social and economic value of monetary stability.

I wish to thank the management and staff of the Bank for the conscientious and constructive manner in which they again performed their duties last year. In the present time of change affecting both organizafional arrangements and technology, working methods must accord even more closely with criteria of efficiency. In managing human resources it is essential to maximize professional skills and improve productivity through dialogue with the trade union organizations and by other means. The plans to expand the Bank's central computing capacity, the development of new procedures and the action taken to increase the branches' operational and analytical potential are closely linked with these endeavours.

The Bank is deeply involved in Italy's many-sided reality, and thus participates in the authorities' campaign to combat the attempts of organized crime to use both age-old means and new opportunities provided by vast financial resources to penetrate the mechanisms that produce and manage the wealth of us all. In accordance with the provisions of the law, the Bank provides its technical expertise and professional resources at every institutional level. In its capacity as the supervisory authority, it takes steps to reinforce the banks' insfitutional defences against infiltration by illegal interests. It strives to ensure that the banking system will become more efficient in gathering the information requested in the proper manner by the bodies that have the difficult task of prosecuting criminal activities.

The world economy. Problems and prospects

Highlights in the world economic picture in 1983 were the vigorous recovery in the United States, its spread to the other industrial countries and continuing stagnation in most of the Third World.

In the United States, the expansive effect of the federal budget deficit was reinforced, partly as a result of the increase in real financial wealth, by a greater propensity to consume and the revival in housing demand. Fears that the recovery might not last long enough to affect investment were dispelled. In the other major industrial countries the end of the cyclical downswing was due mainly to a rise in consumer spending. This upward trend, which subsequently spread to the other components of demand, was fuelled by the massive increase in US imports. Trade in the OECD area expanded more than twice as fast as world demand. However, except in the United States and Canada, there has not yet been any positive effect on unemployment rates.

US monetary policy had allowed nominal and real interest rates to fall in the second half of 1982, although they remained at high levels. However, in 1983 and also in the first few months of this year, the failure to enact measures to cut the budget deficit, together with faster than expected growth, convinced the Federal Reserve Board of the need for stricter control of the monetary aggregates to avoid rekindling inflation. The outcome was renewed upward pressure on interest rates. In Europe, expansion of the money supply was curbed, but not severely enough to prevent the depreciation of European currencies against the dollar. The budget was deddedly restrictive in the Federal Republic of Germany, where policy continues to be directed towards reducing the structural deficit. In Japan, budgetary austerity continued for the fifth consecutive year and the ratio of the public sector borrowing requirement to GDP has been nearly halved to less than 3 per cent.

Prudent conduct of economic policy and, in a number of countries, continuing wage restraint, made possible a further deceleration of inflation. In the OECD area, consumer prices in March 1984 were 5.8 per cent higher than twelve months earlier.

Exchange rate movements made an important contribution to bringing down inflation in the United States. From 1980 to 1983, the revaluation of the dollar lowered inflation by more than one percentage point a year on average. The EEC countries suffered from the opposite effect. A number of European nations have turned to incomes polides and curbs on wage indexation to attenuate the real costs of disinflation. In Japan, the effective appreciation of the yen, wage restraint, and rising productivity have helped hold price rises well below the average for the industrial economies.

The countries of the Third World continued to suffer the repercussions of the debt crisis that had exploded in the summer of 1982, when they were hit simultaneously by world recession, plummeting export prices, high interest rates and the strong dollar. The crisis was further aggravated, especially in Latin America, by a reduction in foreign lending and massive outflows of domestic capital. The initial response was a drastic cutback in imports, which non-oil developing countries have reduced by $60 billion in the past two years, thus cutting their current account deficit in half.

The stranglehold of this combination of factors relaxed somewhat last year. After the precipitous drop recorded in 1982, the exports of non-oil developing countries expanded in volume and in value. The average annual interest costs on their bank debt declined by 2 percentage points in 1982-83, despite wider spreads. 'The combined interventions of the IMF and the major commercial banks prevented the feared collapse in the supply Of finance, with net new lending amounting to around $25 billion and the rescheduling of debt repayments to $40 billion.

Not all of the most heavily indebted countries had their foreign debt rescheduled, however; furthermore, the rescheduling only postponed their onerous obligations for a time, and they may now fall due just as the world recovery weakens. The recent rise in dollar interest rates has not only aggravated the short-term financial situation of the largest debtors but also created new problems for their economic adjustment programmes. Concerted action is needed to maintain a regular flow of funds, to deal with the problem of debt rescheduling in a longer-term perspective and to reduce uncertainty over financing terms. The action taken will have to be tailored to the situations of the individual debtor countries and their progress in domestic and external adjustment. This requires that the creditor banks should continue to provide their overall support with better coordination among themselves, and that the IMF should maintain its surveillance over adjustment programmes and continue to provide finance without impairing its monetary character. Most important, lending by the World Bank, the IDA and the regional development banks needs to be augmented. So far, these institutions' contribution to overcoming the financial difficulties of member countries has been limited by insufficient resources and inadequate procedures.

Exchange relations between the major monetary areas since the second oil shock have been markedly unstable. This can be attributed to the after-effects of the crisis itself, to the new stance of US economic policy, and to the cyclical differences between leading European economies. The attenuation of some of these factors has not brought exchange rate stability, nor caused rates to conform to developments in economic fundamentals.

The increase in the value of the dollar wa's coupled with expanding budget and external account deficits, so that the US currency rose far above the level consistent with the changes in its relative purchasing power. Real interest rate differentials partly explain the trend of the dollar, but not its short-term movements. The improved profitability of investment in the United States also attracted capital, thus helping to drive up the external value of the dollar. This tendency was reinforced by factors that were not strictly economic, such as America's reputation as a safe haven in times of global tensions and crisis.

These interlocking factors force countries to adopt a cautious monetary and fiscal stance, in part because calls for convergence and compatibility in economic policies have gone unheeded. 'There is cause for concern in the possible interaction between exchange rate rnovements, the creation of international liquidity and world inflation. If the current strength of the dollar should abruptly decline, massive portfolio changes would ensue, with a destabilizing impact on foreign exchange markets. International liquidity would not flow towards countries with payments deficits, but to other reserve-currency nations, thus giving them problems of monetary control.

In the current recovery, output and employment trends have been stronger in the United States and Japan than in Europe. However, sustained non-inflationary growth of the American economy is threatened by the large budget deficit, the external current account deficit, and strains in the money and financial markets.

Looking further back, and allowing for the difficulty of making valid comparisons between highly complex and variegated societies, Europe has proved less able to create jobs and expand its share of trade in advanced technology products.

The United States, with the same rate of income growth and with a labour market about the same size as Europe's, though with a faster-growing labour force, has created nearly 15 million jobs over the last decade, while employment in the European Community has declined by more than 3 million. Some 90 per cent of the new jobs in the United States were in the private services sector. In Europe, too, the services sector created the new jobs, but nearly half of them were in the public sector.

All the industrial nations have increased their specialization in exports of goods with a high technological content. In both the United States and Japan, the share of such products in overall exports has risen by 5 percentage points since 1970, while the EEC's gain has been only half that. Within the OECD area, the only country to increase its share has been Japan; the share of the United States has remained constant, while that of the EEC has declined.

The European economy is plentifully endowed with production factors and entrepreneurial skills, nor is there any lack of needs to meet. Realizing the potential for growth, however, will depend on Europe's ability to reduce the rigidities in the allocation of resources, lengthen the horizon of economic decision-making, channel savings into productive investment, and spend more on research.

Since 1960, the amount of savings absorbed by the public sector has risen markedly throughout the OECD area. The share of GDP accounted for by public spending has gone up 13 percentage points to an average of 42 per cent — 34 per cent in Japan, 38 per cent in the United States, and 52 per cent in the EEC. The faster growth of social spending in Europe has also increased the burden of social security contributions. At the beginning of the eighties, these accounted for 40 per cent of the cost of labour in the EEC, as against 27 per cent in the United States and 15 per cent in Japan.

Within the Community, market unification is still hampered by internal barriers. Regulatory and fiscal disparities persist, access to certain sectors remains restricted, and forms of protectionism linger on in the award of public contracts and in product authorization standards. European firms are denied the benefits of doing business in a large, integrated market that are enjoyed by American firms and to some extent by Japanese ones in the Pacific region. This hinders the creation of large European corporations and the introduction of new technology. It strengthens the incentive for cooperation with non-European firms, which can reasonably be expected to contribute more in the way of production technology and market outlets.

The difficulties besetting Europe are not only economic, social and technological but also institutional. The two oil shocks have made governments see the objective of integration as being of secondary importance compared with the immediate need to grapple with the consequences of the ensuing crisis. That objective must again be given priority: only by integrating can Europe hope to meet the challenge created by our major competitors' success in transforming their economies.

The creation of the EMS five years ago represented a leap forvvard in the endeavour to build a European monetary order. The system's record is a positive one, and it has proved to be a valid instrument in the process of monetary policy harmonization. The collaboration that has developed goes beyond the scope of the agreements. The exchange rates of the currencies subject to the EMS constraints have been much less volatile than those of the other principal currencies.

Recently, the trend towards greater European financial integration has regained vigour. The clearest sign of this is the development of the private ECU market. This confirms not only the innovative capacities of European, and especially Italian, financial intermediaries, but also the growing demand for a European monetary unit. The ECU's inherent advantage of greater stability compared with the component currencies and its built-in diversification of exchange risk have not escaped even non-European institutional investors.

The success of the ECU in private markets is a development that many people had not predicted. Its significance needs to be appreciated and the authorities must give operational and institutional encouragement to the spontaneous tendencies of the market. The mechanisms and arrangements of the EMS will also have to be strengthened with a view to the establishment of the European Monetary Fund.

Greater European financial integration presupposes concrete, albeit gradual, steps to harmonize structures and liberalize the movement of capital. If European enterprises are to increase their size, coordinate and finance research, and introduce new technology, steps will have to be taken to promote the mobilization of both equity and loan capital.

The cyclical recovery in the Italian economy

The aim of monetary and exchange policy in 1983 was to curb inflation and support an economic recovery compatible with the state of the Italian economy. The policy of gradually reducing interest rates and the guidelines applied during removal of the ceiling on bank lending maintained orderly conditions in the money and financial markets and ensured that stimulus from domestic demand would not prematurely augment that stemming from exports, which would have jeopardized the return to balance-of-payments equilibrium and the slowdown in inflation.

The rate of increase in consumer prices slowed down from 16.1 to 12.6 per cent in the course of the year. However, the annual average was two percentage points above the target of 13 per cent set by the Government in September 1982, and the inflation differential in relation to the other countries of the European Community widened to 8 points. The increase in lira import prices came to 5 per cent; labour costs in the private sector rose by 16.2 per cent per employee and by 17.5 per cent per unit of output as a result of a fall in productivity. Profit margins narrowed both in industry and in services.

The turning point of the cycle occurred at around mid-year, but it did not prevent a decline of 1.2 per cent in gross domestic product and a fall in fixed investment on an annual average basis. Employment remained practically unchanged; the number of persons unemployed, including workers covered by the Wage Supplementation Fund, rose to 12 per cent of the labour force.

The growth in exports, which exceeded that in imports by more than 3 points, triggered and sustained the recovery in production and, together with the improvement in the terms of trade, helped restore the balance-of-payments current account to equilibrium after three years of recession and deficits totalling 25 trillion lire. Italy's share of world export markets rose from 6.6 to 6.9 per cent. There was a surplus of $600 billion on medium and long-term capital movements, with inflows being almost entirely due to public sector borrowing. Enterprises obtained short-term trade credit from abroad and foreign currency loans from the banks; the banks' net foreign liabilities rose from $10.6 to 12.9 billion between the end of 1982 and the end of 1983. 'The official reserves increased by $6 billion. The country's net external debt remained unchanged at $21 billion, excluding official gold reserves. The lira depreciated by 4.9 per cent in effective terms, by 10.9 per cent against the dollar and by 1.8 per cent against the currencies of EMS member countries.

The combination of condnued rapid inflation and weak economic activity bears witness to the limitations and costs of pursuing adjustment predominantly by monetary means.

The public sector borrowing requirement amounted to 88.5 trillion lire, exceeding the target by 17.5 trillion lire and rising to 16.5 per cent of gross domestic product. Its influence on monetary policy was reflected in the fact that total domestic credit and financial assets expanded by more than had been planned.

Lending to the economy fell 4 trillion lire short of the forecast of 38 trillion. Total domestic credit increased by 20.6 per cent; as a proportion of gross domestic product it rose from 21:3 to 22.3 per cent.

The financial assets of households and enterprises increased by more than 20 per cent for the second year in succession owing to the stimulus from public sector debt, which increased at twice the rate recorded by national income; the ratio between such assets and GDP increased by 7 points to 119 per cent, the highest value recorded since the statistical series began in 1960.

In these circumstances, the Bank sought to create a pattern of market interest rates that was consistent with the need to sell securities to the public and to steer purchasers away from short-term paper towards medium-term securities. To this end it took steps to restrain the growth of the monetary base and coordinated its action with the policy on government debt.

The monetary base expanded by 13.3 per cent; the public's liquid assets increased by 14.6 per cent. The proportion of new assets taking the form of medium and long-term securities rose from 14 to 36 per cent. The maximum maturity for Treasury credit certificates was extended to five years in July and to seven in November; the public debt's average residual term to maturity, which had fallen to an all-time low of eleven months at the end of 1981, moved back up to eighteen months at the end of last year.

As we recalled on this occasion twelve months ago, the continued very high level of inflation in the first few months of 1983 and the need to restore orderly conditions in the government securities market prevented a reduction in interest rates. The expectation of changes in central rates within the EMS also militated in favour of caution. After the March realignment, the signs of an abatement in inflation, the formation of favourable exchange rate expectations and short-term capital inflows permitted a resumption of the downward movement in interest rates that had had to be abruptly reversed in the autumn of 1982. In April the discount rate was reduced from 18 to 17 per cent. The average Treasury bill rate, which had stood at 19.2 per cent at the end of 1982 and was still barely below 19 per cent in February, fell to 17.5 per cent in June.

When signs of a recovery in economic activity began to appear towards mid-year, several risk factors complicated the choices facing the central bank. The public sector borrowing requirement had been held in check in the first half of the year by the effects of the measures taken in 1982 and at the beginning of 1983, but subsequently it threatened to swell again. The salary increases won by public sector employees and the imminent renewal of labour contracts in the private sector made it likely that households' disposable income would increase. A strong growth in consumption on top of the increase in foreign demand that had just begun would have had immediate repercussions on the balance of payments, and the effort to restore profit margins in manufacturing industry would have taken the form of price increases rather than the pursuit of productivity gains. All of these factors suggested the need for a cautious monetary approach. Nevertheless, it was decided not to renew the credit ceiling, relying instead on arrangements for monitoring the trend in bank lending to ensure a smooth phasing out of administrative controls; there was a pause in the downward movement in interest rates.

The cyclical upturn began in the summer. At that time the current account of the balance of payments was barely in equilibrium and the twelve-month inflation rate was still running at 14 per cent for consumer prices and 10 per cent for the wholesale prices of manufactures.

The increase in the public sector borrowing requirement and in households' disposable income fuelled spending and the creation of bank deposits, which grew at an annual rate of 25 per cent in the three months from June to August, more than twice the rate recorded in the first five months of the year.

Businesses operating in export markets benefited most from the cyclical turnround by exploiting the progress they had made in modernizing their production processes and products. In the third quarter economic activity was over 2 per cent higher than in the preceding three months, although enterprises chose not to bring output entirely into line with demand. Sales increased more than production, so that stocks of finished goods declined. The high level of bank interest rates also discouraged the replacement of stocks of raw materials. Bank lending in lire increased at a lower annual rate than output.

At the end of September the Government presented its economic programme for 1984, which reaffirmed that monetary stability and economic recovery are complementary objectives to be pursued by means of a budgetary policy making substantial corrections in the underlying trend of revenue and expenditure, an incomes policy holding down the rise in nominal earnings in line with the intention to reduce inflation to 10 per cent, and a monetary policy operating within this set of objectives and instruments.

In the last three months of the year gross industtial output was 1.5 per cent higher than in the previous quarter, thereby exceeding the levels reached in the closing months of 1982. All components of demand seemed to be heading towards expansion, though to varying degrees. The recovery in the main industrial economies gained momentum, to the benefit of exports, which grew by 3.5 per cent between the third and fourth quarters. The balance of payments on current account remained in equilibrium. Credit demand showed more definite signs of reviving and in the industrial sector the ratio of net interest charges to sales declined.

Consumer prices continued to slow down, but the further strengthening of the dollar affected the lira prices of raw materials, thereby halting the deceleration in wholesale prices.

In the foreign exchange markets, a temporary weakening of the dollar in the early autumn generated tensions within the European Monetary System that also had repercussions on the lira. Control over bank reserves had to be tightened for the purposes of exchange rate stability and in view of the liquidity that had accumulated during the summer. In September the Bank of Italy stepped up the volume of securities repurchase agreements, producing a rise in short-term interest rates. The maintenance of high yields made it possible to increase the supply of Treasury credit certificates and thereby restrict the creation of monetary base through operations with the Treasury. The Bank regulated the liquidity of the banking system by granting fixed term advances; net of central bank lending, the banks' excess reserves fell to an extremely low level in October.

The tightness of liquidity helped bring the growth in bank deposits and in the money supply back into line with the objectives and combined with the monitoring of bank lending to prevent the peaks of credit demand from being met. Sales of government securities produced a steady increase in the unutilized margin on the Treasury's credit line with the Bank of Italy and created the conditions for repayment of the extraordinary advance of 8 trillion lire to which the Treasury had had to resort in January 1983.

From the beginning of the new year onwards the achievements in reducing inflation and the balance-of-payments deficit and in controlling the monetary and credit aggregates created scope for further reductions in interest rates on government paper and removal of the informal controls on bank lending. The official discount rate was reduced by one point in February and a further half point at the beginning of May. Treasury bill rates declined by two points during the first five months of the year and bank lending rates also resumed their downward path.

The fall in nominal interest rates did not prevent the Treasury from covering its borrowing requirement by attracting private savings. The structure of the public debt continued to shift towards longer maturities; net market sales of medium and long-term securities totalled about 30 trillion lire in the first five months of the year. The small scale of monetary base creation produced tighter liquidity and forced the banking system to borrow from the central bank.

The economic recovery is strengthening in many areas of industry. The growth in domestic demand is gradually complementing the expansion in exports; industrial production increased by about 2 per cent between the third quarter of 1983 and the first quarter of this year. Partial restocking to meet the needs of production gave rise to sustained import growth and a rapid expansion in bank lending, the book value of which is inflated by the statistical effect of the expiry of the ceiling and the measures taken during the transitional period.

Inflationary pressures remain strong, despite the progress made; consumer prices are coming down only slowly and wholesale prices are showing signs of accelerating. The revival in world demand is being reflected in the prices of industrial raw materials.

Production costs are being held in check by the combination of productivity gains and the reduction in the degree of wage indexation for the first half of 1984 imposed by the Decree Law under examination in Parliament; however, the difficulties encountered in implementing incomes policy are weakening its effect on prices, partly owing to their impact on expectations.

The reductions in the official discount rate went as far as was possible in bringing down the cost of money by this means. The high public sector borrowing requirement — the actual size of which is still fraught with uncertainty — and an excessive rise in domestic demand could create strains in the financial markets, which would inevitably affect interest rates.

To abandon monetary austerity would jeopardize the gains that have been made on the inflation and balance-of-payments fronts. If the opportunity for lasting growth is not to be missed, the work of correcting the imbalances and inefficiencies that fuel inflation will have to be continued with determination.

Objectives and instruments of monetary policy

After the second oil shock monetary and exchange policy had to be made increasingly restrictive by raising interest rates and, initially, by tightening the constraints on credit institutions and exchange market operators.

In the last four years the domestic public debt has increased at an annual rate of 25 per cent, rising from a 48 to a 60 per cent share of all financial assets. These have expanded at an annual rate of 18 per cent, with the money component falling from 83 to 69 per cent of the total, while the expansion of the monetary base was held to 13 per cent. Total domestic credit has grown at nearly 20 per cent annually; the divergence between the growth rates of the private and public sector components has continued to widen, the private sector's share of credit flows falling from 46 per cent in 1980 to 29 per cent in 1983.

Interest rates peaked in 1981 and then remained at a high level. Maintaining positive real yields on securities increased financial saving, thus limiting the effect of the public sector deficit on spending and making it possible to absorb some of the excess liquidity in the economy.

Positive real interest rates are normal in an economy with balanced growth, and in the past they have not been an obstacle to sustained investment. Exceptionally high interest rates are an inevitable feature of periods of monetary stabilization. The more deeply rooted inflation expectations are, and the less budgetary and incomes policy contribute to stabilization, the higher will be the cost of adjustment. Moreover, if the real interest rate remains above the .growth rate of the economy for any length of time, the progressive increase in the public debt in relation to GDP may prove incompatible with the economy's saving capacity.

It would be illusory to think that a rigorous monetary policy can by itself put public finances back on a sound footing; nonetheless, we can, and indeed must, expect that it should clearly reveal the incompatibility that has grown up between the different claims on resources. In this way it can help clarify the options available and the choices that will have to be made. The inevitability and urgency of these choices are there for all to see. Recognition of the inadequacy of the corrective measures taken so far must be a spur to implement, and not to water down, the adjustment programmes whose basic aims have now been clearly established.

To deliberately expand the monetaiy base, bolster bank intermediation and force interest rates down would imply acquiescence to the monetization of the public debt, creting the conditions for renewed inflationary pressures and accepting the most unjust way of reducing the burden of the public debt — the devaluation of savings. Such a choice is incompadble with the institutional duty of the central' bank. The Bank works to strengthen the currency, not to debase it, in the conviction that the rehabilitation of public finances, a return to growth and the reduction of inflation can be achieved.

Management of the exchange rate was integrated with monetary control not only as regards the formulation of policies but increasingly in their implementation as well. Full monetary stability can only be achieved through consistent behaviour by the social partners and the authorities entrusted with the government of the economy. When this consistency is lacking, an excessively rigid exchange rate wears out the industrial fabric; an exchange policy that stimulates cost reduction and product improvement can nonetheless make a decisive contribution — as it has in the last few years — to the curbing of inflation.

Another aim of our work in the field of monetary policy is to promote techniques for the regulation of money and credit that will increase the efficiency of the markets.

At a time when the size of the budget deficit and the difficulty of controlling its growth rendered the independent conduct of monetary policy both more necessary and more arduous, the progress made towards better control over central bank financing of the Treasury, by eliminating its underwriting function, was of fundamental importance both in principle and in practice.

The Bank of Italy finances the government primarily through two channels. The Treasury's current account overdraft facility was introduced as a means of increasing the flexibility of its liquidity management at a time when the short-term securities market was narrow, not as a permanent and privileged source of funds. Over the years the much faster rise in public expenditure than in income, coupled with the fact that the overdraft limit was linked to expenditure, caused a relative increase in this form of automatic monetary base creation that threatened to make the whole aggregate uncontrollable.

The other channel the Bank of Italy uses is the purchase of securities. Since 1981 these purchases have been entirely discretional, thus giving substance to the legislative limits on Treasury borrowing from the central bank, which are intended not only to regulate a technical instrument but also to enable monetary policy to pursue stability.

The extraordinary advance from the Bank of Italy to the Treasury that Parliament approved in January 1983 was an exceptional event — the consequence of the use of the Treasury's current account becoming increasingly deviant. In the months that followed the granting of the advance, the Treasury gradually improved the situation of its current account until it was in a position to repay the advance, within the time laid down by the law authorizing the loan. But this satisfactory result was more the outcome of higher interest rates than of a correction of the trends of revenues and expenditures.

Reaffirmation of the principle that monetary policy should be separate from management of the public debt was accompanied by innovations in funding the borrowing requirement designed to facilitate sales of securities in the market and improve control over the monetary base.

As regards the supply of government stocks, the Treasury has rationalized its recourse to issues of longer term securities and its auctions of short-term paper by spreading them over each month. Issues of the former, which are regulated in accordance with market demand, rose to 86 per cent of the total net issues of government securities in 1983. Treasury bills were restored to their function of providing marginal finance. Their yields must be free to vary sufficiently to ensure that issues are taken up completely at auction.

In 1983, 71 per cent of the net purchases of government securities by the public and credit institutions were made at issue and the rest in the secondary market. Prior to 1981 virtually all these purchases were intermediated by the Bank of Italy.

In these circumstances, in which the Treasury seeks to meet its needs in the market and a greater proportion of monetary base is being created through market operators, central bank lending to financial intermediaries in the form of advances and repurchase agreements is again becoming an important means of regulating liquidity. The maturities of fixed term advances have been set in days instead of weeks; the criterion for calculating interest value days has been revised; and the interval after a borrowing in which a subsequent borrowing triggers higher rates has been shortened. These changes make recourse to this instrument more flexible and less penalizing.

The Bank of Italy's repurchase operations in the secondary market expanded considerably, helping to neutralize the effect on the monetary base of the larger fluctuations in the balance of Treasury operations as well as making liquidity available on settlement days.

Since last March an experiment has been running with a voluntary group of intermediaries that guarantees to tender for a large proportion of the Treasury bills issued each month. The group can count on short-term financing by the Bank of Italy and performs the function of advancing and concentrating the demand that builds up over the month as Treasury expenditure generates liquidity. There is a corresponding reduction in the amount of securities the Bank of Italy takes up to sell in the secondary market.

The decision to rely more on monetary base control in the management of money and credit requires that interest rates be sufficiently mobile, both upwards and downwards. This means that financial institutions, and in the first place banks, will have to respond promptly even to small changes in market conditions. It also implies that there will have to be universal recognition of the impossibility of simultaneously imposing the quantity and the yield of the public's financial saving without annulling market mechanisms completely.

The disaffection with fixed rate long-term securities was the spontaneous, inevitable consequence of the persistence of inflation. The recourse to variable rate instruments has allowed borrowers and lenders to enter into multi-year contracts again. Compared with a short-term loan that is rolled over repeatedly in the market, a long-term variable rate debt involves not only lower transaction costs but also less risk of sudden difficulty in obtaining renewal. Compared with fixed rate bonds of the same maturity, variable rate securities expose borrowers to unforeseeable extra interest costs. Conversely, however, they reduce the premium that has to be paid to overcome the reluctance to invest of savers who have been badly burnt by inflation.

If the desirable revival of long-term fixed rate financing has so far had to be put off in view of its costliness, the policy of creating a money market and diversifying the public's financial assets has checked the erosion of monetary control due to the coexistence of a huge public debt with a high rate of inflation. In the years when financial wealth consisted almost entirely of bank deposits, and securities were taken up mainly by banks, monetary base impulses reached businesses and the public indirectly and with long lags, since their transmission depended on the behaviour of the banking system. Today, not only do changes in the yields on securities affect the ability of banks to raise funds, and hence the supply of loans, but they also have a direct and immediate effect on the behaviour of savers and firms.

Variable rate Treasury credit certificates are not money, either in a legal sense or in usual payment practices; nor is there a commitment to convert them into monetary base in the short term, as there is for Treasury bills. The fact that yields on a large proportion of government securities are directly linked to short-term rates lightens the debt burden as inflation slows and interest rates come down. On the other hand, a rise in interest rates increases the burden and reduces the restrictiveness of monetary policy. If inflation does not abate, the advantages of variable rate securities are curtailed and become all the smaller, the larger the public debt and their share in it grow. The search for new instruments and better debt management techniques may be useful, but a lasting assurance of the efficient working of financial markets and of the independence of monetary policy can only come from a reduction in the public sector's voracious appetite for saving.

Banking supervision

The central bank's supervisory activity has to be closely tied in with monetaiy policy and designed, in combination with that of the other competent authorities, to increase the efficiency and soundness of financial intermediaries and markets.

A purely administrative view of supervision weakens the links with monetary policy and thereby diminishes the effectiveness of both, but two other extreme positions appear equally detrimental. It is sometimes claimed that supervision can be used to mould financial structures into any desired configuration and eliminate any and every imperfection in their operation. More often it is imagined that supervisory controls can be all-pervasive and prevent all irregularities, inefficiencies and insolvencies among not only banks but also all companies selling securities to savers.

The first interpretation overrates the scope for engineering the credit system, whose structure is determined by a great many market and regulatory forces; and it underrates the obstacles that economic analysis encounters in determining the optimal conditions of financial intermediation. The second involves an excessive risk of saddling the central bank with the ultimate responsibility for the fate of individual intermediaries and for the outcome of individual positions. Such an approach would run directly counter to the principles underlying market economies and would seriously weaken monetaiy control by forcing the central bank to enter into specific commitments of an administrative and financial nature.

The protection of savings and the effective performance of the credit function are best ensured by a system of intermediaries and capital markets that can provide a stable and efficient framework for the supply of the services the economy requires. The task of the regulatory authorities is to create the basic conditions in which this ability can find full and independent expression. This involves both controlling and stimulating, partly by acting directly on members of the system and partly by preparing general measures and guidelines.

Parliament has recently extended the public control over the capital markets to mutual funds and atypical securities. This task has been entrusted to the Companies and Stock Exchange Commission (Consob) and the Bank of Italy, in accordance with the complementary nature of their responsibilities, which is made all the more effective by the working relationships between the two institutions.

The authorization of securities issues expresses no judgment on the solvency of issuers or the profitability of securities. It improves the monetary authorities' control over both the total flow of funds and its distribution among the major sectors of the economy and different financial instruments; it avoids possible sudden crowding-out effects caused by new issues with terms that differ too much from the market average; in short, it is consistent with the aims of credit control, including the maintenance of orderly conditions in capital markets. The excessive difference between the control procedures on atypical issues and the more comprehensive ones for shares and bonds may well influence issuers' choices. Uniform procedures should be introduced that would stnle a balance between the two extremes.

The authorization required by the Banking Law if issues are made through banks or the stock exchange is also designed to prevent a recurrence of the links between industry and finance that aggravated the crisis in the thirties. The transparency of banking and stock exchange business requires that the information to be supplied about the ownership of even unlisted banking companies should be specified by law.

Under the regulations governing mutual funds the supervision of their management companies will use some of the instruments of preventive regulation and successive monitoring that the Banking Law foresees for the broader and more detailed control of credit intermediaries. Foreign mutual funds operating in Italy still need to be brought under supervisory controls in addition to the existing exchange controls. The Government has recently approved a bill to fill this gap.

The banks play a basic role in financial intermediation: their deposits are the most common form of savings investment and the foundation of the payments system. The very nature of bank deposits suggests that their holders are relatively averse to risk and perhaps poorly equipped to assess it. The main focus of supervision must therefore continue to be on banks; even though it cannot guarantee the outcome, supervision must promote the efficient management of banking business.

The supervision of banks and special credit institutions has been strengthened, with attention now being paid not only to lending, capital adequacy and profitability but also to the quality of the organization of administration and accounting, with special reference to decision-making bodies. The regulations have been modified to improve supervisory effectiveness by eliminating administrative procedures that have become obsolete.

As regards shareholdings, the limits -within which credit institutions may operate without having to obtain prior authorization have been clearly defined. Strict regulations governing this aspect of banking business were laid down and provision was made to review them in the light of experience. The special credit institutions have been left free to issue savings certificates and medium-term certificates of deposit as they wish, provided they conform to the guidelines that have been established. The avoidance of excessive concentration in these institutes' lending is now entrusted to a range of quantitative parameters rather than to case-by-case authorization as in the past. Turning to the geographical limits on banks' lending operations, a revision of the regulations and procedures involved is nearing completion and the new system will allow substantially greater freedom.

If operators in credit markets are not to be faced with uncertainty, the exercise of control must follow clearly stated general criteria. Balance sheet ratios can be useful and, when appropriate, they are used, but as summary indicators that enhance rather than detract from the discretionary element in supervision.

Our present policy is to revise the operational regulations so as to extend banks' freedom of action, simplify supervisory controls and make them more effective. The purpose is to make them more powerful instruments in a broader action to foster entrepreneurial abilities in financial intermediation. If this greater scope for independent action is to be fully exploited, the cdterion of professional competence will have to be strictly adhered to, first and foremost in board and top management appointments.

The basic aim of the Bank of Italy's supervisory activity is to enhance the scope, internal competition and stability of the credit sector.

Only a system of diversified financial structures can satisfy the complex, changing requirements of the economy. This is confirmed by the universal trend towards a wider range of financial intermediaries, institutions and instruments.

In the last ten years of high infladon and pronounced financial imbalances between sectors, the markets succeeded in expanding their intermediation business, in part through rapid, large-scale technical innovation in securities. The first Italian mutual funds — some already . authorized and others about to be so — are likely to start operating in a matter of months. How much this will strengthen the capital markets will depend on how far the growth of the mutual funds themselves, firms' willingness to be listed and issue shares, and the start of merchant banking can be integrated. My remarks on merchant banking at last year's meeting triggered wide public discussion. Many operators have expressed interest in entering this sector on the authorities' condition that banks be clearly distinguished from other firms. Concrete proposals are at an advanced stage of preparation in the credit system and measures are being drafted to modify the regulations on banks' shareholdings so as to allow them to participate.

Increasing importance is attached to the objective of fostering competition, but through measures that will also counter undesired side-effects. Many of the structural changes that have been made in the Italian financial system in recent years have tended to increase competition permanently, albeit gradually.

The development of the securities markets has undermined the dominant position of bank deposits and widened savers' choice of investments.

The domestic credit system has become much more open to foreign competition. Starting from the interbank and corporate markets, foreign banks will be able to extend their operations to sectors of the retail market.

Branch authorization plans have promoted the entry of new banks into areas that had previously been dominated by long-established banks. Rather than being extended, the network needs to be rationalized. Policy in this field will seek to increase competition and efficiency as well as to strengthen banking services where demand is rising. Within the limits established by the criteria and numerical parameters laid down by the authorities, the banks will have greater scope to relocate existing branches.

The principle upon which the regulation of banking has been based is the need to create a uniform system by smoothing the edges of the division of intermediaries into different categories when this results in similar services being supplied on different terms.

The dispersion of bank deposit rates about the average has gradually diminished and is now close to that of lending rates. The removal of the ceiling on bank loans allows market forces to act freely. Another step in the same direction was the banks' abandonment of agreed guidelines for the prime rate in favour of each bank setting its own.

The competitive pressures produced by changes such as those introduced in the last few years are being relied on to curb banks' costs and margins, apart from any changes cyclical and monetary policy developments may produce. The banks' interest and gross earnings margins were virtually unchanged in 1983. The banking system will have to respond to the sometimes rather generic accusations of inefficiency levelled against it by enhancing the professional skills of management and staff, lowering the incidence of costs, innovating in organizational structures, in the quality of services and in the criteria for attributing expenditures and setting charges. Banks will have to take full advantage of the opportunities opened up by automation and more viable company size, to be achieved through mergers and takeovers in the medium-to-small size categories, and the joint management of services produced at competitive costs.

Market forces do not threaten, and in the long run will increase the stability of the Italian credit system. Nevertheless, banks and special credit institutions must continue to strengthen their capital bases: between 1979 and 1983 the ratio of own funds to borrowed funds rose from 5 to 8 per cent, in part as a result of the law passed in 1983 permitting the revaluation of assets. The lessons of the past, including the recent experience of other banking systems, confirm the need to build up provisions against the risk inherent in lending both to domestic customers and to heavily indebted countries abroad.

Only a few days ago the international legal dispute triggered by the failure of Banco Ambrosiano was settled with the signing of two agreements. The first was between the liquidators of Banco Ambrosiano and the creditors of the Luxembourg holding company and its foreign subsidiaries; the second, between the above and Istituto per le Opere di Religione. The settlement confirms the soundness of the position taken by the Italian monetary authorities; from the very first, they had recommended cooperation between the liquidators and the creditors as the best way to attenuate the effects of the failure. The agreements are the necessary condition for the realization of assets, which, together with the IOR's financial contribution, will enable both the creditors and the liquidators to recover large sums.

This concludes an important aspect of this serious case, which originated in fraudulent practices. The Banco Ambrosiano affair has spotlighted the need for greater international cooperation in banking supervision and underscored the requirement that the supervision be on a consolidated basis, which is not yet provided for under Italian law. Steps will also have to be taken to modify some anomalies arising from special territorial situations that have led to banking business being conducted outside the control of the Italian supervisory authorities.

The duties of the central bank are not limited to encouraging the credit system itself to develop better solutions to the problems of insolv' ency, but require it to improve the means for preventing cases of illiquidity from leading to failure.

It is essential that it should command a wide range of instruments for providing funds to individual banks at official rates. Performance of this function, which is basic to central banking, is hamstrung in Italy by outdated, inflexible legislation that limits the scope for supporting intermediaries with liquidity problems that lack securities for collateral or access to the interbank market. More specifically, the choice of assets eligible as security for Bank of Italy lending may perhaps be excessively restrictive, especially for banks under special administration.

Within the framework of current legislation the technical innovations introduced in the last few years have allowed total bank liquidity to be regulated through secondary market operations together with a more flexible use of fixed term advances to individual banks. Since the role of ordinary advances in offsetting the shortcomings of the interbank market is diminishing, they will be better able to satisfy banks' special requirements.

It is essential that the lender of last resort should be able to deal immediately with any liquidity problem that arises. But it must avoid creating the impression that the concession of central bank refinancing is a foregone conclusion. Only such a course can safeguard both stability and an efficient and prudent approach to risk assessment.

The prospects and conditions for a resumption of growth

The slow progress in reducing inflation and the seriousness of the problem of unemployment make it essenfial to broaden our analysis to include the set of conditions that must be achieved in public sector finance, in the productive sector and in incomes growth if the cyclical upswing is to be transformed into stable expansion.

In no other industrialized country has the public sector deficit remained so large for so long. The problems generated by the interaction between accumulated debt a.nd repeatedly large deficits are becoming critical. Public expenditure, including debt servicing, equalled 41 per cent of gross domestic product in 1974; by 1983 it had risen to 63 per cent. Revenue increased from 32 to 46 per cent over the same period, but failed to keep pace with the growth in expenditure. The ratio between the public debt and gross domestic product rose from 58 to 85 per cent.

The disequilibrium was due partly to the nature of Government policy, which reinforced its income redistribution function.

Social security expenditure absorbed an increasing share of national income, rising from 16 per cent in 1974 to 22 per cent in 1983. Pensions accounted for a large proportion; their share rose from 8 to 13 per cent of GDP and will expand further owing to demographic factors and the rules governing the pension system.

The crises in the productive sector caused subsidies and loans to enterprises to increase from 3 per cent of the value added of the industries involved in 1974 to 7 per cent in 1983. Over the same decade the government granted more than 20 trillion lire to the state holding companies, 13 trillion lire in the last three years; these vast sums were used not to finance new investment but mainly to cover part of their operating losses, which amounted to about 15 trillion lire in those three years.

Over the same decade, tax revenues increased to the point where the ratio of taxation to GDP approached those of the other Western European countries, partly as a result of the reforms of the early seventies; in the last three years the ratio rose by 7 points. The increase came primarily from direct taxes and from a tax base that is narrower, de jure and de facto, than in other countries. There are major exceptions to the principle of universal taxation: some categories of income are tax-exempt, others are assessed on a purely conventional basis and tax evasion appears to be quite widespread.

Despite a number of corrective measures that have been taken, the financial imbalance is tending to worsen. Budget projections for the period from 1984 to 1988, which are based on the assumption of unchanged expenditure behaviour and take account of population trends, indicate that the rafio between the public sector borrowing requirement and gross domestic product will stay at the present level while the public debt will substantially exceed gross domestic product, even if inflation continues to fall, the recovery strengthens, the ratio of taxation to GDP gradually rises by a further two points and real interest rates on the public debt remain in line with economic growth.

The significance of such exercises, to which reference is made in the body of the Report, is clearly limited, not only because of their underlying assumptions but also their failure to take account of the feedback effects of the budget on real growth and prices. Leaving aside the figures themselves, the results nevertheless confirm the dilemma that the large public sector deficit and burgeoning debt are creating for monetary policy: whether to allow credit and the financial assets of the economy to expand at rates incompatible with non-inflationary growth in their more liquid components, or to induce a steady rise in real interest rates, with serious repercussions on investment and incomes.

A programme of action must be devised as a matter of urgency to eliminate the imbalance in public finances that has built up over the years; this should comprise measures to curb the growth in expenditure, increase revenues and limit the public debt and the debt servicing burden and should be constructed in such a way that they reinforce one another.

The effectiveness of a programme designed along these lines is endorsed by the results obtained by introducing a number of more demanding hypotheses into the calculations. For example, if the annual growth in expenditure -were held down to a rate 2 points below that in GDP and the ratio of taxation to GDP were gradually increased by 3 points from its present level but the other assumptions remained unchanged, the borrowing requirement net of interest payments would tend to diminish rapidly and would practically disappear over a period of five years. The debt burden would decline considerably in relation to income, because the reduced demand for funds would permit a reduction in real interest rates. The rise in the ratio between public debt and GDP would slow down and eventually stop. The overall state of public finances would then allow a better balance between the money supply and issues of securities and release new savings for increased investment.

Operational criteria that would hold the rise in expenditure to a rate consistently below that in output over the next few years are as difficult to apply as they are simple to draft; they would have to be sufficiently flexible, but without undermining their value as an indicator of the adequacy of the measures taken. In certain sectors, such as social security and health care, the need for changes that would restore control over the growth of expenditure was identified some time ago. Wages and salaries throughout the public sector would have to be held in check within the context of restrictions on the rise in all earned incomes.

On the revenue side, substantial increases might be obtained by improving administrative efficiency and taking specific measures to limit the scope for tax evasion and erosion of the tax base. The proposal to reduce the number of VAT rates and to institute more rigorous controls and verification procedures would go some way towards extending the tax net. Steps must also be taken to neutralize the effects of indirect taxation on the price indices that govern wage indexation.

Improved information on the actual and prospective state of the public finances would help reaffirm the rigorous provisions intended by the Constituent Assembly with regard to the budget and the financing of legislation entailing expenditure. Law 468 of 1978, which reformed important aspects of government accounting, acknowledged the need for well-defined and methodical decision-making procedures. However, the excessive recourse to special funds in financial legislation, the inadequate adherence to multi-year budgets and the fact that observance of the funding requirement under new spending legislation is often limited to the portion required for its first year of application have prevented the establishment of systematic control over public finances.

A public sector borrowing requirement that absorbs a growing proportion of households' saving and a public debt of vast and continually growing dimensions impose constraints on monetary policy, thereby adversely affecting the volume and cost of credit flowing to the productive sector. The opportunities and prospects for growth in the latter also depend on the state in which it emerges from the recession.

The cycle that began in 1978 and ended in the middle of last year comprised an initial period of vigorous expansion followed by the longest recession since the fifties. During this second phase the fall in production in Italy was smaller than in the other OECD countries. Investment activity continued for some time after demand expectations had become less auspicious; most important, the new capital goods embodied more advanced technology and production processes.

The urgency of the need to respond to changes in relative prices was accentuated by the second oil crisis, which broke when firms had still not absorbed the effects of either the first crisis or the explosion in wages and salaries. The flexibility provided by the Wage Supplementation Fund, which is itself in need of reform, and by an improvement in industrial relations meant that, despite the absence of labour mobility, productivity was no longer a by-product of the production process but could again be treated as the objective to be achieved in order to be competitive.

Technical innovations helped make production more flexible, partly through greater specialization in individual stages of manufacture, which was particularly beneficial to small and medium-sized enterprises. Competitiveness was regained both in sectors with large firms and a high price elasticity of exports and in industries where product quality is of paramount importance. Manufacturing industry as a whole recorded growing surpluses in its foreign trade, partly because the stagnation in domestic demand forced enterprises to turn to foreign markets.

The supposition that Italy is undergoing a process of deindustrialization, a hypothesis modelled on the debate taking place in other countries, is not borne out by empirical evidence, even though the Italian economy's response to the problems that have arisen in the past decade has been slow and incomplete.

With a few significant exceptions, Italy's share of world trade in products embodying advanced technology remains marginal. In other important sectors that are wrestling with crises on a world scale or are afflicted by long-standing structural deficiencies there has been delay in taking the necessary action.

In more general terms, little headway has been made in presenting industrial policy as a comprehensive plan in the European context. There must be clarity and continuity in the influence that the public sector exerts on the composition of supply and demand. Advances in productive activities require external economies that will be achieved by improving professional training and raising the efficiency of collective services. In the light of experience, sector-specific measures should be rethought and the scope for administrative discretion reduced. Only recently has the problem of redefining the rationale, means and limits of the state's direct involvement in productive activities been stated in operational terms.

For too long the state-controlled enterprises have been expected to resolve social conflicts; this has led to lax management, losses and the withdrawal of private capital. A large number of public sector enterprises cannot be restored to health unless the streamlining and restructuring measures are fully implemented. In others, profitability stands comparison with that in the private sector, but their operating results are seriously undermined by the impact of interest charges on their gross operating margin, sometimes owing to capital inadequacy from the outset and sometimes as a result of losses incurred in the years of more acute economic crisis.

A viable manufacturing sector able to contend with foreign competition continues to be the foundation for the development of the entire economy. However, success in world trade also depends on the ability of the rest of the economy to incorporate innovations and to put them to good effect. A more efficient utilization of resources is needed in service industries, which are less exposed to foreign competition. They account for a large share of general costs, and hence significantly influence industrial competitiveness. The increase in prices has been greater in sectors not exposed to international competition than in those that are; measured in terms of the implicit price deflators, the disparity averaged three percentage points a year between 1979 and 1983.

Marketable services comprise a broad and varied range of activities. The more advanced services, which provide enterprises with financial and management consultancy and electronic data processing capacity, are still of minor importance. Transportation, communications, finance and insurance are largely the preserve of medium-sized or large firms; nevertheless, the benefits of organizational improvements and economies of scale are not infrequently lost for lack of incentives to efficiency. Other branches of the services sector are dominated by family firms with low productivity and little by way of fixed assets.

The increase in employment in the private services sector and in general government has been considerable, amounting to 25 per cent over the last decade. Despite this intake, which partly reflects the difficulties in the labour market, unemployment has taken on serious proportions and characteristics; the average number of persons seeking work rose to 2,280,000 in 1983, or 2,700,000 if workers covered by the Wage Supplementation Fund are included.

The disparity between the youth unemployment rate and that for other age groups has widened in all the industrial countries; there is a real danger that we shall fail to give the younger generation a reasonable expectation of employment. The outlook is much more worrying in Italy, where one young person in three is looking for work; by way of comparison, the proportion is one in four in the United Kingdom, one in five in France, one in six in the United States and one in nine in the Federal Republic of Germany.

In Italy the number of entrants to the labour market will continue to be large for the whole of the next decade. Assuming constant participation rates according to sex and age, the labour force will expand at an annual average rate of 0.4 per cent until 1993, increasing by 900,000 in absolute terms. However, if one assumes, in line with recent experience, that activity rates among women will rise slightly, the growth in the labour force will amount to 1,500,000 by 1993.

Complefion of the process of resource reallocation and growth in incomes and employment require a steady accumulation of capital and equilibrium in the balance of payments on current account; the legacy of past deficits makes it inadvisable to borrow further sums in the international markets, while underlying exchange rate stability and wage restraint are essential if inflation is to be brought permanently into line with the rates prevailing in the other industrial countries.

Given the elasticity values for Italy's imports and exports, international demand and price scenarios suggest that long-term growth will be below the rate required to reduce unemployment. If national income and employment are to expand more rapidly, the external constraint must be eased; steps must be taken both to reduce the propensity to import, beginning with energy products, and to improve the ability to penetrate world markets by increasing the competitiveness of exports and switching to products with a higher value added that are likely to account for a rapidly growing share of world trade.

The creation of such conditions depends upon an intensification in investment, even if the benefits are not reaped until later. This might lead to an increase in the ratio of capital to GDP. If growth is not to be affected, the proportion of income saved and allocated to investment will have to rise. Savings formadon declined from 23 per cent of gross domestic product in the early seventies to 18 per cent in the last three years, mainly owing to the expansion in the current account deficit of general government. It is crucial that this trend be reversed, and this is the point at which stabilization policies and policies to steepen the growth path converge.

There are no automatic mechanisms that can guarantee the transformation of saving into investment; investment decisions, and hence the conditions in which they are made, are the driving force behind growth. The rise in wages and salaries stimulates the introduction of new technologies and changes in the structure of output, on which productivity gains also depend. Beyond a certain limit, however, it raises production costs and increases the pace at which labour is replaced by other production factors, thereby destroying new job opportunities. Continuity of investment requires a pattern of income distribution that avoids wage/price spirals and leapfrogging wage increases in the knowledge that combatting inflation coincides with safeguarding employment.

Ladies and Gentlemen,

The development of an economy is the result of cyclical, structural and institutional components that are more interdependent than can be described in a formal analytical framework.

Our actions to control money and credit and the remarks we have made in this, and other settings over the years have been motivated by the conviction that Italy's drift away from stability and growth must be rectified for reasons that transcend the merely economic. In the exercise of this office, we have warned on several occasions that monetary stability, the prime concern of the central bank, is related to the state of the public finances, of the productive sector and of the labour market, which are themselves closely interlinked. It was an awareness of these links that led us to assert three years ago that central bank autonomy, the tightening of budgetary procedures and a code of practice for collective bargaining were prerequisites for a return to monetary stability.

When the budget deficit inflates the public debt year by year and causes it to grow faster than national income, economic policy as a whole is jeopardized and the very possibility of countercyclical budgetary measures is endangered.

No economic logic can be invoked to support the monetary illusion that slower growth in nominal incomes entails a greater sacfifice than higher inflation. Within the context of measures to moderate all the indexation mechanisms, the *scala mobile* will have to be revised in ways which experience suggests can help to reduce inflation and absorb the effects of exceptional external events.

In past years the authorities took steps to moderate the adjustment costs of the crisis in terms of production and employment; the initial impact was cushioned by large-scale drawings on the foreign exchange reserves and foreign borrowing, which were employed to the maximum extent consistent with preserving Italy's internacional creditworthiness. Even when Italy had to face the most perverse interactions between prices and the exchange rate and between the budget deficit and the public debt, the necessary decisions were taken without losing sight of the longer-term problems. Reaffirmation of the principle that regulation of the money supply and management of the public debt should be separate, the modifications in the techniques of monetary control and the innovations urged or introduced in the financial system are aimed at increasing the effectiveness of the defences against disequilibria and strengthening the system's contribution to investment and growth.

The economic upturn has also begun in Italy, but the rate of price increase has not yet fallen to a level suggesting that the long period of inflation that began in the seventies has ended. The need to transform the recovery into stable and lasting growth goes hand in hand with the need to curb inflation while domestic demand is rising. These are not conflicting objectives, but two inseparable strands of one and the same problem.

The Italian economy has been beset by inflation and stagnation for far too long; for far too long, behaviour inconsistent with the need to reallocate resources and with the changed balance in world economic relations has given prices the impossible task of reconciling the irreconcilable, thereby stifling the prospects of growth. The conviction that high and prolonged inflation undermines every distributive mechanism and disrupts economic activity has slowly gained ground; if this realization is now widely shared, there cannot fail to be agreement on the corrective measures that are clearly required.

It is both necessary and possible to re-establish monetary stability and return to the path of growth. The Italian economy is not the victim of some mysterious canker.

The worldwide recoveiy has created a favourable economic climate; at home, exchange rate stability and productivity gains deriving from a higher degree of capacity utilization are helping to curb the increase in costs. However, unless expectations of a continued slowdown in prices are validated by continuity of intent and consistency of behaviour, the present combination of improved business confidence and a satisfactory composition of demand will once again give way to pressures emanating from the budget deficit and rising costs, to a rekindling of inflation and to the reappearance of external imbalance. It is within our power to prevent a relapse that would undo the progress so painstakingly achieved and offend the nation's conscience.

The conditions for restoring and maintaining stable growth that will open up the prospect of work for the younger generation are demanding. The capacity to save constitutes the foundation for such growth, and the will to invest provides the driving force; a distribution of national income that guarantees constructive patterns of behaviour is an essential requirement.

By curbing expenditure, fighting tax evasion and erosion of the tax base, enforcing the requirement to formulate multi-year budgets, complying with the obligation to provide tax cover for new expenditure and tightening budgetary procedures, fiscal policy will be able to stem the flood of public debt and release savings for investment.

As an adjunct to fiscal policy, incomes policy will have to be designed to check the rise in costs and to ensure that the newly created resources do not exclusively benefit those already working — employees and self-employed, public and private — but are used to reduce unemployment, strengthen the industrial base and bring sustainable balance-of-payments equilibrium.

It will be the task of the central bank to conduct monetary and credit policy in a manner consistent with curbing the rise in prices, to ensure an orderly flow of funds into investments, and to spur the banking system to greater efficiency.