BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1985

THE GOVERNOR'S CONCLUDING REMARKS

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At the opening of this Meeting, the minds of all those who are in any way connected with this Institution will be turned to Donato Menichella with sincere and heartfelt recollection.

I wish to pay tribute to him in this forum just as I did at the meeting of the Board of Directors last July.

Others have already spoken about his lifetime of activity that spanned half a century and has already become a part of the country's history; much more still needs to be said.

I recall the Menichella who governed the Bank of Italy for twelve difficult but excitingly productive years. He ran the Bank with a firm confidence that stemmed from his outstanding ability, with an openness to ideas that reflected his acute and high mind, with a strict and reserved style imposed simply through moral strength and the consistency of his life. The lesson that effective government of the currency is also fostered by discretion is a legacy that the Bank values highly.

Rigorous intellectual discipline, a wealth of experience in many fields and a highly developed sense of service to the community were all endowments of the Bank before the appointment of Menichella, who inherited the guidelines laid down by Stringher and Einaudi. His actions were in perfect accord with that tradition, which he both epitomized and enriched, especially with his lucid and passionate commitment to the development of southern Italy.

Intellectual clarity and honesty were the basis for the firmness of Menichella's convictions, which were never dogmatic, and for the originality of his judgements, which were never preconceived. This attitude, which expressed his spirit even more than his mind, enabled him to explore the intricate paths leading to the reconciliation of efficiency with social demands. He recognized and cultivated the strong complementarity that exists between market forces and openness to international trade on the one hand, and public intervention and control on the other. He adopted the same pragmatic approach in his conduct of the Bank's affairs, fruitfully combining the functions of monetary policy and banking supervision, marrying austerity with complete confidence in the ability of the staff and a humanity that was the hallmark of all his actions.

For Menichella, a sound central bank able to neutralize the causes of instability inherent in credit systems by emphasizing preventive measures of monetary management and banking supervision was the indispensable basic condition for a balanced economy. He strove tenaciously and successfully to ensure that this condition would be satisfied in Italy: first by contributing decisively to the solution of the industrial and financial crisis of the thirties, which threatened to compromise the central bank itself; then by helping to define the institutional framework that still ensures the proper working of the credit system and the independence and effectiveness of the Bank of Italy's operations; and finally, as Governor, by using that independence and effectiveness to promote the steady development of the whole economy in the late forties and fifties.

However, a well-managed central bank alone might have been insufficient. It was especially important in an economy such as Italy's, with its longstanding geographical dualism and pronounced sectoral imbalances, that the Bank's action should be set in an even broader framework defining both the system whereby economic activity is governed and the conditions for structural interventions in the economy.

It should not be a surprise, though it is undoubtedly evidence of a comprehensive and farsighted vision, that Governor Menichella should have sought to develop ideas and plans for the institutions and instruments of industrial and regional policies.

Responsibility for such institutions and for the management of these instruments does not lie with the central bank and should not be entrusted to it. Nonetheless, only by eliminating the underdevelopment and even poverty of whole areas of the country would it have been possible to defuse the most dangerous "real" causes of instability. These are the causes with which monetary and credit policy is least well equipped to cope, and yet precisely those that can generate the greatest pressure for the involvement of the central bank in choices threatening to undermine its independence and ability to control credit.

Menichella successfully guided the Bank of Italy and the Italian economy through a decisive transformation, inspired by his awareness that instability does not stop at prices but attacks production and employment as well as saving and investment, thereby prejudicing the development of the economy.

Menichella combined this awareness, which was enhanced by his direct experience of some of the most traumatic events in Italian economic history, with farsightedness and an ability to formulate strategies for the long term, in which the objectives were set in conformity with carefully considered options and the instruments chosen in the light of their effectiveness for the task.

Menichella's style, his pragmatism and the discreet silence he observed for twenty-five years after retiring from the Governorship enhance the value of the heritage he has left the Bank and the country.

Let us pay homage to Donato Menichella in the quiet manner he preferred. As Luigi Einaudi said of him, "This is the man who abhors `noise' in connection with his actions". May his example inspire us in attending to the affairs of the Bank.

To increase our knowledge of the thinking and the achievements of Donato Menichella — first in the clarification of the regulation, ownership and management of banks and industry, and then in the government of the currency — the Bank of Italy and IRI have decided to organize a day of study and tribute to be held next January.

In order to commemorate Donato Menichella, the Board of Directors has approved the creation of two scholarships bearing his name, to be awarded to young graduates wishing to continue their study of development economics or credit legislation.

Carmelo Oteri, Deputy Director General, passed away last June. For more than forty years he had served the Bank with complete dedication, spending his entire career in the institution and giving it the benefit of his wide and varied experience. An authority on the working of the Bank, both in the Central Administration and in the branches, he was particularly involved with banking supervision and internal auditing, fields in which his ability to achieve results, his integrity and his discretion came to the fore. After becoming a member of the Directorate in 1982 he made valuable contributions to numerous aspects of the Bank's administration while continuing to monitor the problems of banking supervision.

He displayed an exceptional sense of dedication to the very end, bearing the pain of his illness with calm fortitude, determined to attend to the demands of his office. We all remember him with us in this room last year, a noble demonstration of devotion to duty.

Tommaso Padoa-Schioppa has been appointed to the Directorate. Having worked with him for many years, I am confident that the Bank will continue to benefit from his balanced judgement and technical competence.

The world economy, Europe's backwardness, the exchange rate system

The most significant international economic developments of 1984 were strengthening expansion and a further deceleration of inflation. Only in North America, however, was economic growth robust enough to reduce unemployment. In Europe, by contrast, the number of jobless rose to over 18 million. The external position of the developing countries improved, while payments imbalances and exchange rate disequilibria among the leading industrial countries worsened.

Gross national product in the OECD area increased by nearly 5 per cent, the fastest rate since 1976, powered principally by American domestic demand, which rose by 9 per cent. GNP grew by 7 per cent in the United States, 6 per cent in Japan and just over 2 per cent in Europe. World trade expanded by 9 per cent, trade between industrial countries by 14 per cent.

Despite the sustained expansion of economic activity, cost and price inflation slowed, thanks to non-accommodating monetary conditions, wage restraint and slack markets for primary products and oil. In the OECD countries, hourly wages in industry rose by 5.5 per cent, slightly less than in 1982 (from 1973 to 1982, the average annual rate of increase had been 11 per cent). On average for the seven leading industrial economies, unit labour costs in industry did not rise. The figures varied substantially from country to country, however, and this was reflected in inflation rate differentials. At the extremes, the increases in the GDP deflator and in labour costs were nearly ten percentage points higher in Italy than in Japan.

The exceptionally strong expansion of demand in the United States meant large-scale resort to savings from abroad. The need for additional resources was engendered chiefly by soaring investment. Net private investment jumped from $56 billion in 1982 to $95 billion in 1983 and over $230 billion last year. The balance-of-payments deficit on current account more than doubled to over $100 billion. In addition to the inflow of private capital from abroad, financing for the deficit was also provided by US banks which, in view of surging domestic demand for credit and the narrowing of lending opportunities elsewhere, sharply cut acquisitions of overseas assets from 1983 onwards.

The strains in US financial markets generated by the strict conduct of monetary policy were augmented by the federal budget deficit, which rose from $128 billion in 1982 to $185 billion in 1984. Failing significant corrective measures, the deficit will inevitably rise, even if the economic expansion continues.

A contributory factor in the evolving pattern of payments balances and exchange rates was the different mix of monetary and fiscal policies pursued in the other industrial countries. In Europe and Japan, the curbing of the public sector borrowing requirement and less restrictive monetary conditions eased the upward pressure on interest rates.

Confirmation of the new pre-eminence of financial transactions in determining exchange rates is found in the continued appreciation of the dollar despite the growing US payments deficit on current account. In 1984 the dollar gained 6 per cent against the yen, 21 per cent against sterling and 13 per cent against the other EMS currencies. Nominal and real interest rate differentials, the strong US expansion, the high expected yield on capital and the security of investments all helped bring about a notable diversification of portfolios, especially in Europe and Japan, and sustained the rising dollar.

The upward course of the US currency came to a halt only when signs of a slowdown in US economic growth appeared and only when, after a further steep rise in January and February, concerted action by the central banks of the main industrial countries reminded the markets that exchange risk is not a one-way proposition. The Bank of Italy took an active part, convinced of the usefulness of intervention in such cases.

Adjustment programmes enabled the developing countries to take advantage of the growth in the OECD area, significantly improving their external accounts. As defined by the IMF, the current account payments deficit of all the debtor countries decreased to $38 billion, as against the $113 billion registered in 1981. The improvement has been continuous, but whereas from 1981 to 1983 it stemmed chiefly from import containment, last year it was due entirely to export gains. The aggregate deficit of the seven most heavily indebted countries, which had stood at $40 billion in 1982, fell to $11 billion in 1983 and $1.5 billion last year.

The overall foreign debt of the developing countries has thus begun to decline in proportion to exports, and its maturity structure has improved. In the past two years debt totalling $228 billion, almost all with commercial banks, has been renegotiated. The agreements with Mexico and Argentina extended repayment deadlines by as much as fourteen years in some cases, and the margin over the base rate was halved.

The IMF has played its part in making this achievement possible, not only with its own lending but also by drafting economic adjustment programmes and promoting and coordinating finance through private markets.

Finding a definitive solution to the debt crisis is a long-term task for the international community, and future periods of renewed crisis are not out of the question. If the domestic effects of the policies by which the most heavily indebted countries have improved their external positions are to be bearable in the long run, these countries need to gain broader access to private markets and sufficient official funds. The current trends must be reversed. Budget problems have led most industrial countries to trim foreign aid and financing, and even the development banks have slowed the pace of lending. More than anything else, the determined pursuit of appropriate policies by the most heavily indebted countries requires sustained growth of demand and imports in the industrial countries.

The expansive thrust of the US economy is waning, and the other leading economies are having trouble filling America's role in sustaining world growth. In particular, even acknowledging the need to maintain monetary stability, the expansion of domestic demand in Japan and Germany remains modest, providing insufficient stimulus to fulfil these economies' growth potential.

The economic policies pursued by the major industrial countries, their interaction and their timing are crucial to the expansion of output and employment in the entire world economy. Inappropriate policies would further aggravate tensions in the exchange markets, worsen international financial imbalances and intensify the pressures making for the fragmentation of world trade. The foundations of international economic cooperation would be undermined.

The slow growth of output and investment in Europe not only damages world economic expansion but also jeopardizes the very capacity of Western Europe to retain its leading role in the international political and economic arena.

European growth is being held back by regulatory constraints, widespread market rigidity and a lag in technological innovation. In recent years the possibilities for expansion have been limited in many countries by restrictive fiscal policies aimed at scaling down the oversized public sector.

The continued restraint required in countries where adjustment has been incomplete should be complemented, in those where more headway has been made, by a less restrictive fiscal stance, temporarily buoying private investment and gradually lowering the incidence of taxation on income. Such measures would help smooth the transition to a new balance between the public and private sectors without impeding efforts to curtail the public sector's role.

Not only must Europe expand the volume of aggregate demand, it must also strengthen the productive base of the economy.

The technological challenge posed by the United States and Japan goes beyond industrial primacy: job creation and economic growth will depend on an intensified research effort, on the introduction of new technology and on accelerated capital formation.

The importance of advanced industries consists essentially in their ability to apply and disseminate technological changes at a time of rapid innovation. The process also takes place through the creation of new enterprises throughout the economy, their expansion, the elimination of the least able, and a shift of employment into the industries and regions where there is a demand for labour. If this evolution is impeded, the economy stagnates or declines.

For too long now the construction of the European Community has been marking time. What has been lacking is the ability to devise and put into operation institutional arrangements and decision-making procedures that can complete the creation of a unified European market for factors of production and products.

The readiness of businessmen to respond promptly to innovation stimuli has been diminished by the limited mobility of labour and capital, the rigidity of the wage structure, the impediments to the movement of goods and the inefficiency sometimes connected with the expansion of the public sector. The emphasis on keeping and defending what we already have has ultimately worked to the detriment of entrepreneurial initiative and the ability to create jobs. Difficulties have also been encountered in implementing the industrial policy guidelines for tackling excess capacity in particular industries and promoting common programmes in such fields as telecommunications, data processing and basic research. Also lacking, finally, has been the stimulus to technological innovation that might derive from better coordination of public investment expenditure.

The rise of truly "European" firms, with European-wide operations, financing and access to research findings, is hindered by institutional and market segmentation.

One limitation is the incomplete integration of money and financial markets. Of necessity, their integration can only proceed together with economic convergence and institutional harmonization.

The successful working of the EMS should not mislead us into underestimating the latent tensions. Significant advances have been made in relations between central banks and in strengthening the ECU in private markets, and more progress may follow. But the ultimate gauge of the system's performance is success in creating an area, of monetary stability. Progress towards that objective has been unsatisfactory.

The increasing use of the ECU underscores its potential as a vehicle for monetary integration, but turning that potential into reality will require stronger official suppo rt: in particular, the recognition of the ECU as a currency by all the members of the Community. This would mean greater use of the ECU in stabilization interventions within the EMS. It would open up the prospect of a significant enhancement of the role of the European Monetary Cooperation Fund, both in the coordination of exchange market intervention and in concerted supervision of the creation of ECU-denominated deposits and financial assets.

The increase over the years in the volume and mobility of international capital flows has amplified the impact that largely uncoordinated national policies have had on exchange rates and aggravated the difficulties of regulating international liquidity. Increasingly, the demand for reserves has been met by market borrowing. The creation of reserves has come to depend in large measure on the banks' assessment of the creditworthiness of borrowing countries and on monetary conditions in the leading economies.

Longstanding uncertainty about the markets' ability to reconcile competition and stability has acquired new urgency. It is true that international financial operators can cover themselves against exchange or illiquidity risks, but when a series of unfavourable events takes on macroeconomic importance, the monetary authorities have a duty to safeguard stability, and the cost must be borne by the entire community.

The Group of Ten is currently engaged in a thorough discussion of the necessary conditions for less unstable exchange rates between the major currencies and better control over international liquidity. The report drafted by the G-10 Deputies will be presented at next month's meeting of Finance Ministers and central bank Governors in Tokyo.

I am convinced that we cannot afford to relax our commitment to pursue more stable exchange rates, even though today no practicable alternatives to the floating rate system are in sight.

The system of flexible exchange rates did help produce balance-of-payments adjustment to a series of jarring shocks to world economic equilibrium. Nevertheless, changes in the real exchange rates of the leading currencies of the order of 50 per cent, first in one direction and then in the other, as we have experienced in the last decade, are bound to produce distortions in resource allocation and engender the risk of sudden, sharp corrections with dangerous implications for economic and financial stability. The temptation of each country to seek a way out of its difficulties by imposing limitations and constraints on foreign trade may recur.

Exchange market intervention by central banks can curb speculation and counter temporary market disorder. If it is not neutralized, and therefore influences domestic monetary conditions, such intervention can affect market trends.

Restoring better-balanced international monetary relations will require greater convergence between developments in the major economies and compatibility among their fiscal and monetary policies. The likely international repercussions must weigh more heavily in national economic policy decisions, and exchange rate stability must once again become a high-priority objective. These goals can be pursued through multilateral surveillance, endowing the IMF with broader and more incisive powers to urge adjustments when the policies adopted by the leading countries fail to produce sufficiently stable exchange rates.

Once the present disequilibria are on the way to solution, consideration should be given to establishing target zones for exchange rates between the major currencies as a possible way of strengthening discipline; their implications for market intervention and domestic economic policies would have to be accepted. The experience gained in running the EMS may prove helpful in this respect.

Moreover, a convergence towards non-inflationary growth and economic policy compatibility would make a major contribution to the more orderly expansion of international liquidity. Measures are also necessary to improve the working of private markets in liquidity creation and to bring about a suitable balance between private and public sources of funds.

As to the first point, it is closer cooperation among supervisory authorities above all else that can help stabilize the international banks' contribution to liquidity creation, as was noted at the Third International Conference of Banking Supervisors in Rome last September. As to the second point, the IMF's role in coordinating the flow of credit to debtor countries in the last few years may be a harbinger of broader liquidity-regulating functions. The regular creation of even limited amounts of SDRs would strengthen the Fund's role and enhance the stability of the system by making at least some portion of international reserves independent of the risk assessments of the banks and the monetary policies of the major countries.

Finally, it is worth re-emphasizing the distinction and the complementarity between the two central institutions of the Bretton Woods system. Specifically, better coordination between them could ensure that the gradual decline in recourse to Fund credit with the end of the most acute phase of the debt crisis is accompanied by a sufficient expansion in World Bank lending to facilitate structural adjustment.

The slowdown in inflation and the recovery in output in Italy: progress and difficulties

A year ago, in describing the state of the Italian economy, I said that there were no obstacles to a return to balanced, non-inflationary growth that could not be overcome by wide-ranging, determined action. At that time, the economy was responding positively to a convergence of economic behaviour and measures adopted over time in all areas of economic policy. Subsequent events, with a first phase of favourable results and expectations followed by a second phase marked by the emergence of new difficulties, have shown that this judgement was well founded. Indeed, I feel that it deserves to be reiterated today.

The strict stance of monetary and exchange rate policy was reinforced by a number of measures: first, an incomes policy, which consisted in setting guidelines for wage increases and encouraging compliance with them by means of the agreement of January 1983 and the measures of February 1984; secondly, measures to curb the expansion in the public sector borrowing requirement; and finally, a careful graduation in the increases in utility charges and administered prices.

This combination of measures brought a change in expectations; despite the appreciation of the dollar, it made it possible to achieve a marked slowdown in inflation at the same time as a recovery in output and investment. By the autumn, however, while the expansion in investment had strengthened, the budgetary and incomes measures were already encountering obstacles, with a consequent loss in continuity and effectiveness. Monetary policy continued to have a restrictive stance, which was reflected in high nominal and real interest rates. The relaxation of demand and cost constraints coincided with the pause in the slowdown in inflation and the worsening of the trade deficit.

On average, the figures for 1984 reflect the prevalence for most of the year of the positive aspects I mentioned. The target for inflation was essentially achieved, with consumer prices rising by 10.8 per cent, four points less than in 1983. The inflation differential between Italy and the rest of the EEC narrowed from eight points to five. After eleven years of double-digit inflation, the rate of increase in the cost of living fell to less than 9 per cent in the autumn. Real gross domestic product expanded by 2.6 per cent, ending the recession that had begun in 1980.

The rise of 8.0 per cent in labour productivity in industry, an exceptional figure even for the initial phase of a cyclical upturn, offset a large part of the increase of 13.7 per cent in per capita labour costs and held the increase in labour costs per unit of output down to 5.3 per cent. Since the prices of other inputs of goods and services rose by 11.7 per cent, the increase in total industrial costs per unit of output came to 8.8 per cent.

The economic policy measures, the unchanged monetary stance, the lower inflation rate and the lira's satisfactory performance in the EMS created a climate of greater certainty in which the restoration of profit margins, firms' improved self-financing capacity and the need to continue with restructuring the productive sector stimulated an expansion of 4.1 per cent in gross fixed investment. Expenditure on machinery and equipment rose by more than 10 per cent, making good a large part of the decline that had begun in 1981.

The rise in output and investment was accompanied by an increase of 60,000 in employment; though far from sufficient to absorb the growth in the labour force, this is indicative of the service sector's potential for creating jobs, which are declining in agriculture and manufacturing industry. As a result of the increase in the labour force, the number of unemployed rose by 128,000 to just under 2,400,000, of whom almost half are first-time job seekers.

To consolidate and continue this simultaneous improvement on both the output and inflation fronts while maintaining external balance, additional measures would have had to be taken in the course of the year to maintain the curb on costs and prevent a new surge in the public sector deficit.

By contrast, increasing difficulties were encountered in implementing incomes policy. Whereas in the private sector gross per capita wages rose in line with prices, in the public sector they increased by 2.3 per cent in real terms. Furthermore, the measures to broaden the tax base for income from self-employment and entrepreneurial income could not be introduced until the end of the year.

The measures aimed at increasing revenue and reducing expenditure succeeded only in limiting the underlying deterioration in public finances. Over the year as a whole, the Treasury borrowing requirement, which is the financial aggregate available on a monthly basis, came to 95,350 billion lire; as a ratio to GDP, it was one percentage point less than in the preceding year. However, there was a further increase, from 13.9 to 14.7 per cent of output, in the public sector's net borrowing, the difference between non-financial receipts and expenditure, which have a more direct impact on the demand for goods and services; the deterioration in the ratio is reduced, but not eliminated, if interest charges are excluded.

In the second half of the year, the stimulus generated by fixed investment was only partly offset by the containment of consumption and stock-building. The expansion in domestic demand gained momentum, with serious repercussions on the balance of payments.

The effect was most evident in imports of goods and services. Whereas in 1983 they had stagnated in volume terms, in 1984 they rose by 9.6 per cent, primarily owing to increased purchases of capital goods and intermediate products. The increase in the lira value of imports was accentuated by the appreciation of the dollar. Moreover, exports began to slow down at mid-year. Though rising by 7 per cent in volume during the twelve months, they failed to profit fully from the growth in world demand. Gains in the United States market offset part, but not all of the losses sustained in the Community countries. The situation was aggravated by the worsening of the trade deficits vis-à-vis some North African and Eastern European countries, owing largely to difficulties unconnected with price competitiveness.

Developments in 1984 once again highlighted the structural weakness of Italy's foreign trade, to which I shall return in due course. The less than satisfactory results from tourism contributed to the renewed deficit on current account after the modest surplus of 1983 had broken the string of substantial deficits recorded in the preceding three years. The 1984 deficit came to 5.2 trillion lire, with an appreciable deterioration in the second half of the year.

In this situation, monetary and credit control benefited at first from the dual commitment to incomes and fiscal policies. When the effectiveness of these weakened, the control became more difficult.

In the first few months of 1984, the slowdown in inflation and the improvement in expectations had made it possible to reinforce the decline in nominal interest rates by making two cuts in the discount rate, one in February and the other at the beginning of May.

In the late spring the credit aggregates began to accelerate. The banks expanded the supply of credit by borrowing abroad. The initial signs of a deterioration in the trade balance indicated an excessively fast growth in domestic demand that high interest rates were not sufficient to curb. At the end of July it was decreed that the banks' net foreign borrowing should not exceed the June level at constant exchange rates.

The acceleration in the credit aggregates was confirmed by the July data and spread to bank deposits. Corrective action was decided upon at the beginning of September. The discount rate was increased by one point to 16.50 per cent and bank liquidity was severely tightened. Interest rates on bank loans responded promptly. The increase in the yield on Treasury bills of up to 6 months and in the first coupon of Treasury credit certificates reinforced the demand for Treasury securities. At the same time, it became clear that the real economy was growing faster than had been forecast, particularly investment; accordingly, the Interministerial Committee for Economic Planning approved an upward revision of two percentage points in the annual target rate for the expansion in lending to the productive sector.

The measures had the effect of curbing the growth in credit to the economy. In the autumn the slowdown in inflation continued and the fall in nominal interest rates on government securities was resumed. These developments, together with the approval of the Finance Law and the introduction of fiscal measures by decree law, made it possible to reduce the discount rate to 15.50 per cent on 3 January.

Over the year as a whole, the trend of interest rates on government securities followed that of inflation, with a lag that disappeared in the first few months of 1985. The yield on Treasury bills has fallen by three points since the beginning of 1984 and that on Treasury credit certificates by nearly five, calculated on the basis of the first coupon. Over the same period nominal bank lending rates have declined by almost two points.

The year-on-year expansion in the monetary and credit aggregates did not diverge appreciably from the targets set in

September. Adjusted for changes in the compulsory reserve ratio and for random movements in the last few days of the year, the monetary base expanded by 11.4 per cent, two points less than in 1983. The money supply, net of certificates of deposit, grew at about the same rate. Credit to the private sector increased by 15 per cent and total domestic credit by 19 per cent. Under the pressure of the state sector borrowing requirement, holdings of financial assets rose by a further seven points in relation to GDP.

In the new year the growth in the state sector borrowing requirement accelerated further. The expectation that a referendum would be held on the reduction in wage indexation enacted in the first half of 1984 accentuated the uncertainty about the future course of industrial relations, costs and prices. The deterioration in the trade balance grew worse.

The lira depreciated within the EMS from mid-February onwards, whereas throughout 1984 improved confidence in the Italian economy and the nominal interest rate differentials had kept the lira strong to the point that substantial purchases of Deutschemarks were made. The movement was accentuated by the depreciation of the dollar in the principal foreign exchange markets. The situation stabilized in April. Since the realignment of March 1983, Italy's price competitiveness in terms of real exchange rates has declined by 2 percentage points with respect to the EMS countries and increased by 1 point in relation to the other main OECD countries.

In the first four months of 1985 lending to the private sector continued to grow at the slower rate recorded in the latter part of 1984 and in line with the target for 1985. However, the expansion in the state sector borrowing requirement caused the growth in total domestic credit and the non-state sector's financial assets to accelerate; the expansionary monetary pressures intensified as a result of the Treasury's demand for credit, so that in the first four months of the year the money supply, net of certificates of deposit, increased at an annual rate of 15 per cent.

In January and February, when uncertainty was not yet the dominant influence on expectations, the demand for government securities was concentrated on the primary market owing to the short-term effects of a change in fiscal regulations. The legislation had the desired effect of removing the incentive for firms to borrow in order to buy securities, but in the short term it also reduced the substantial sales of government securities that the banks usually make from their own portfolios in the first few months of the year. The January and February issues of Treasury credit certificates were heavily oversubscribed owing to widespread expectations that applications would be scaled down; this largely fictitious excess demand gave the fleeting impression that interest rates might decline further. In March the demand for securities fell sharply, whereas the borrowing requirement continued to expand; the overdraft on the Treasury current account was used to the full.

In April it became necessary to raise the yields on government securities to sustain demand and slow down the creation of monetary base via the Treasury. The rise in interest rates on securities was not accompanied by a similar movement in bank rates; the widening of the yield differential between government securities and bank deposit rates will help bring the monetary aggregates back on course.

In many ways, the data available so far on the state of the Italian economy paint a disturbing picture. The state sector borrowing requirement amounted to about 37 trillion lire in the first four months of this year, 9 trillion lire more than in the same period of last year, displaying a trend incompatible with the targets for 1985. In the first quarter the trade balance registered a deficit of more than 8 trillion lire, twice that of the first quarter of 1984, a trend that is broadly confirmed by data on the balance of payments on a cash basis up to April. Domestic demand is expanding faster than in other major countries. There has been no slowdown in consumer price inflation for six months, while the rate of increase in wholesale prices has accelerated since the beginning of the year.

Monetary policy is therefore seeking to limit the repercussions of these imbalances. However, a more vigorous incomes policy and prompt budgetary measures are needed to remove the factors causing the deterioration of the Italian economy and restore a climate of confidence.

The path to growth and employment

The close links in the Italian economy between cyclical difficulties and structural problems have been thrown sharply back into relief by the reappearance of storm clouds. It is therefore apposite that we should re-examine the long-term issues that were raised at last year's Meeting and ask what conditions will be necessary to avoid dissipating the progress that has been made and to permit a strengthening of the productive economy, the prerequisite of sustained and balanced growth.

Studies conducted by various institutions have confirmed the seriousness of the risk that demographic developments together with the composition of labour supply and demand will entail an increase in unemployment. The national rate, not counting workers on Wage Supplementation, is 10.4 per cent, rising to 14 per cent in the South. Three quarters of the unemployed are less than thirty years old. Projections up to the early nineties, when demographic pressures will have eased, indicate an increase in the labour supply of between 150,000 and 200,000 persons per year — largely in the Mezzogiorno.

The southern question thus re-emerges as the key to the economic and social progress of the whole Italian nation.

The obstacles to a return to stable growth and at the same time the potential for such a development are most directly evident in connection with the external accounts and investment.

The openness of the Italian economy, which has increased in recent years, offers opportunities for a more efficient use of resources and a greater satisfaction of needs. These opportunities will have to be grasped by giving a positive twist to the stimuli emanating from foreign trade. By contrast, the conditions obtaining today inside and outside Italy mean that our economic and financial relations with the rest of the world act in various ways as a severe constraint on growth.

Over the last five years foreign debt has expanded to finance current account deficits amounting to 29 trillion lire. At the end of 1984 the net external position, excluding the gold reserves, amounted to — $23.5 billion. In this situation small current account deficits financed with capital inflows can be accepted, provided they are temporary and matched by investment designed to increase the country's competitiveness and productive capacity.

The prospective expansion of the world economy in the medium term will not in itself be enough to loosen the current account constraint. Forecasts made by international organizations indicate that the average annual growth in the industrial countries' GDP through 1990 will not exceed 3 per cent and the expansion in world trade 5 per cent, while inflation is expected to run at around 4 per cent.

Italian industry's technology and the private sector's propensity to save do not rule out the possibility of our economy growing faster than others. Nonetheless, the factors generating inflation and the current values of the fundamental determinants of Italy's foreign trade force growth to be at a slower rate than is needed to reduce unemployment.

On the assumption that the volume of exports will grow over the next five years at the same rate as world trade, that the terms of trade will remain unchanged and that the income elasticity of imports will stay close to its medium-term value, the annual GDP growth rate compatible with current account balance is around 2.5 per cent. With productivity rising at a rate of approximately 2 per cent, the excess supply of labour could continue to increase and amount to nearly 3 million persons by 1990.

Notwithstanding the limits of such exercises, the above scenario confirms the need to act to modify the parameters of the Italian economy, starting with those relevant to our foreign trade.

The trade deficit includes a number of structural components, originating in the weakness of whole sectors. The burden of imports remains substantial for food and agricultural products, and above all for energy.

Even large and persistent deficits in specific sectors can be offset by other items of the trade balance. What counts, in the final analysis, is an economy's ability to produce efficiently and specialize in activities that make the best use of its comparative advantages and domestic resources. The surplus on manufactures has risen considerably, even in real terms, but this effort has not sufficed.

Over the last five years the real exchange rate of the lira, calculated on the wholesale prices of manufactures, has fluctuated moderately about a virtually flat trend. A greater nominal depreciation could have aggravated inflation and would have further delayed the modernization of the productive system and the search for cost savings while providing only a temporary improvement in firms' export prospects. Relaxing the rigour of exchange rate policy today would not only revive inflation but also threaten to halt the positive developments under way.

In several sectors, including engineering and textiles, Italian industry has succeeded in increasing its share of the world market as a result of innovations in production processes and improvements in product quality. For the most part, however, industry is still geared to exporting goods for which the growth in world demand is slow and whose technological content is relatively small.

The new products and production processes require a high proportion of imported intermediate goods. However, the really worrying development is the increasing import penetration of final goods, which are by no means limited to capital goods.

There are still limits to the ability of domestic supply to satisfy the demand for an increasingly varied range of products, even though manufacturing industry has been realizing the necessary modernization through automation and the introduction of new technologies ever since the 1978-80 investment cycle. More efficient and flexible capital goods have largely replaced the earlier equipment, which was made rapidly obsolete by the acceleration in technical progress. The new equipment has entailed a general decrease in both labour and capital per unit of output. It has also encouraged the development of a more diversified productive system, comprising a growing number of highly versatile firms.

The restructuring of the manufacturing sector has been accompanied by an improvement in firms' capital structures. Companies have been able to improve their profit margins and increase the flow of equity capital. The ratio of net worth to fixed assets has improved. The scale of indebtedness has decreased. Public aid has supported the regeneration of industrial firms, imposing a burden on the budget. It will now be possible for greater attention to be paid to the aims of development in assessing and deciding further aid.

Industrial restructuring needs to be focused to an even greater extent on sectors allowing exports with high demand elasticities and low price elasticities or that offer a potential for import substitution. In the phase we are currently traversing, the increase in the propensity to import is the price that has to be paid to acquire and develop the necessary technologies and to expand export markets. To abandon this process in mid-stream would entail giving up the benefit, in terms of a lasting ability to export, that was the justification for incurring the cost.

The need to invest in restructuring is not restricted to the sector exposed to international competition. The interaction between industry and services requires that the effort to curb costs and prices and to upgrade supply be extended primarily to the sectors that meet domestic demand and the needs of industry itself — i.e. government and most of the services sector. It is in a more efficient services sector, geared towards the provision of new services, that the opportunities for creating new jobs will mostly lie.

The creation of employment depends on investment coupled with more flexible labour relations. The whole economy's propensity to save will have to rise, in the first place through a reduction in the public sector's dissaving. Only in this way will it be possible to finance the volume of investment needed to complete the current phase of innovation in plant and production processes and simultaneously broaden the productive base.

The changes made since the second oil crisis are evidence of an economy that has found the drive to promote adjustment and growth. But if inflation and unemployment are to be overcome, the response of the productive system will have to be reinforced by returning public finances to an even keel, holding down wage increases, reorganizing labour market institutions, and renewing the commitment to the development of the South.

Curbing government current expenditure would increase the scope for intervention not only in infrastructures but also in the fields of research, innovation and vocational training — prerequisites of increased employment. Industrial policy will have to be focused more on creating conditions that will support firms' commitment to higher productivity and technical progress than on providing blanket protection for declining sectors. In particular, it can help to improve the proportions of imported and domestic technology. The implementation of Law no. 46 of 1982 on applied research and innovation has shown that there is no lack of projects. The ability to make this aid reach the South and small firms needs to be enhanced.

The various quantitative hypotheses put forward for the adjustment of public finances have so far given rise to few concrete measures. To set public finances on such a course will require considerable government action; the need for this is widely recognized; its inevitability stems from ten years of large deficits. In the last few days the Treasury Minister's targets for adjusting the government's finances and curbing the public debt were reset and clarified. As a first step it is important that a correction be made to the overshoot of the budget aggregates compared with the objectives for this year, so as not to have to advance the base line of the multi-year strategy.

The correction of the trend growth of expenditure must aim at eliminating the borrowing requirement net of debt interest. If it is to have lasting effects, the adjustment must involve the reform of the sectors that tend to push up the deficit most, such as social security, local government and health care. Some of these sectors already suffer from serious imbalances that are destined to become incompatible with the equilibrium of the whole economy, while others provide services that suffer from qualitative shortcomings of a scale and frequency suggesting inappropriate administrative and organizational arrangements.

As a further step in the adjustment process, it is necessary to strengthen the rules and institutional arrangements for ensuring economic compatibility in the procedures for deciding expenditure. A significant advance would be made by reformulating the rule laid down in Article 81 of the Constitution in the manner proposed by the Commission for Institutional Reforms — the principle of balance between current outlays and tax and other receipts; the obligation for every bill to be accompanied by the report of a technical body quantifying the related expenditure commitments; increased powers for the Court of Auditors; and special majority rules for the approval of expenditure laws returned to Parliament by the Head of State as breaching the above-mentioned provision of the Constitution.

During the adjustment phase public sector wages will have to respect the guidelines laid down by the Government for labour incomes in the whole economy. Coupled with a fairer distribution of the fiscal burden, this condition forms the cornerstone of a far-reaching policy for incomes designed to grapple with both inflation and unemployment. A society that is truly concerned about the problem of unemployment must be ready to subordinate every other economic interest to the creation of new jobs.

The experience gained in 1984 confirms that holding down rises in nominal incomes can reduce the pressure on prices and defend competitiveness, thereby protecting employment without prejudicing real earnings. The additional resources made available by gains in productivity must flow into investment to increase the availability of jobs, encouraged where necessary by appropriate fiscal or fiscal-related measures.

It is only recently that legislation has started to incorporate changes that will better enable labour relations to cope with the need for added flexibility created by technological advance. Innovations in this area could include part-time work, the coordination of labour mobility, and incentives for vocational training and retraining. These are the principles underlying the plan for employment drawn up by the Minister of Labour. If its objectives are to be achieved, the first problem that will have to be tackled is that of automatic wage adjustment mechanisms, in conjunction with that of pay differentials.

Setting the budget to rights is also indispensable for a renewed attack on both the old and the new economic imbalances in the Mezzogiorno.

In the last thirty years the southern economy has undergone an unprecedented process of transformation and development. The result can be summarized in terms of per capita income, which tripled in absolute terms and rose from 51 per cent of the figure for the rest of the country in 1960 to 62 per cent in 1973. Since then the gap has ceased to narrow.

Nor is it possible to envisage a revival of mass emigration as a solution to the socially disruptive problem of unemployment in the South.

The productivity gap with respect to the Centre and North of Italy discourages new ventures and the creation of jobs. The relief granted on social security contributions is designed to offset this handicap, but the remaining discrepancy gives rise to wage differentials and higher levels of unemployment.

The primary task of public intervention, however, is to eliminate the differences in productivity by generating external economies, improving infrastructures, and promoting new productive ventures and capacity in the Mezzogiorno.

The objective of loosening the external constraint, which acts as a brake on the whole economy, is at one with the need to continue the modernization of southern agriculture. The growth of technologically advanced sectors can also be encouraged by giving preferential treatment to investment in the South, both in industry and in services. The potential for tourism needs to be exploited to the full.

The development of southern Italy is entrusted in the first place to the organizing ability and commitment of society in the South. The administrative and entrepreneurial skills that have already emerged in some areas would benefit from decentralization of the instruments and powers associated with public intervention. By contrast, the powers of effective coordination that the law has entrusted to central bodies remain of vital importance for the stimulation and support of productive ventures in the weakest areas.

Money and finance

When dealing with instruments of monetary control and financial structures, the objectives of bringing down inflation and generating growth are pursued in tandem so as to exploit their complementarity. The main obstacles are the difficulties affecting public finances, which distort financial flows and make it imperative to keep real interest rates high.

The long series of measures to develop a money market in Italy made it possible to manage money and credit predominantly by indirect means and at the same time encouraged reliance on such methods.

More recently, the removal of the ceiling on bank lending has stimulated competition among the credit institutions; the rates of growth in lending by individual banks have begun to diverge, whereas in the past they were necessarily uniform, and the interest rates charged by different banks to similar categories of customer have become broadly the same. Between 1982, the last year in which the credit ceiling was fully operational, and 1984 the dispersion in the rates of lending growth more than doubled, while the range of variation between the minimum interest rates of the thirty largest banks diminished from 4 to 2 percentage points. The margin between lending and deposit rates narrowed. The recent change in the regulations governing tax-free securities purchased by firms gave the banks a further incentive to shift from portfolio investment to lending.

The tendency for loans to recover their predominant position in bank assets reinforces the link between banking institutions and productive activity and that between monetary base and credit.

By enhancing their ability to set the terms and conditions for deposits and loans in the light of market trends, the banks help make the transmission of monetary policy faster and more effective. Interest rate responses have improved in recent years, but they remain slow and too strongly conditioned by expectations of changes in official rates, and operators do not make full use of the information to be gleaned from liquidity trends and market movements.

In the new configuration of the credit market, the key elements of monetary control are sales and purchases of securities, the refinancing of banks, and compulsory reserves.

The provision of finance to the banks and securities repurchase agreements act as a link between the permanent supply of monetary base, which is managed in accordance with the annual targets, and the banks' demand for monetary base, part of which is inelastic in the short term owing to the lagged payment of compulsory reserves. By using the various means at its disposal for temporarily influencing reserves, the central bank causes banks to make choices and behave in ways that will put the monetary aggregates back on course. Depending on circumstances, it relies on market mechanisms or on regulating the quantity of money, allowing wider fluctuations than under a system of direct controls. In 1984, deferred payment securities transactions, securities repurchase agreements and fixed-term advances came to a gross total of more than 100 trillion lire.

New provisions that came into force at the beginning of this month introduced a commission on central bank overdraft facilities and made it possible to revoke them even for limited periods, thereby allowing credit lines to be adjusted to the actual needs of individual banks and making them controllable for the purposes of monetary policy.

The pressures that public finances exert on the growth in monetary base are impairing the compulsory reserve instrument's function as a stabilizer of money creation. In these conditions a high reserve ratio is an indispensable corrective. Like every constraint, compulsory reserves limit the banks' operational freedom and impose a cost. In the short term the unchanging rate of return on compulsory reserves increases the effectiveness of interest rate policy in regulating the money supply. Despite the increase in the reserve ratio, the cost of keeping reserves has tended to decrease in recent years with the fall in interest rates and the strengthening of the banks' capital bases. Furthermore, there has been a gradual narrowing of cost differentials between the various types of banking institution, which until 1975 were subject to regulations that differed widely, partly depending on the composition of their borrowed funds. The average reserve ratios of banks of national interest and savings banks now constitute the two extremes of the range, but the difference has narrowed to five percentage points.

A monetary and credit policy designed to restore stability requires that the government should raise the finance it needs primarily in the market. Substantial progress has been made towards meeting this condition: firstly, the reform of Treasury bill auctions in 1975, which introduced ample scope for interest rates to fluctuate and, most recently, the agreement in 1981 whereby the central bank's purchases of securities at issue are discretionary and dictated purely by the objectives of monetary base control.

In 1984 more than 90 per cent of investors' purchases of government securities were made in the primary market, compared with 45 per cent in 1982. This healthy development contrasts, however, with the scope for monetary financing of part of the government deficit utterly unconstrained by market mechanisms or monetary policy, thanks to the legal provision tying the limit on the Treasury's overdraft facility to approved budget expenditure. This provision has allowed the facility to expand by an annual average of 29 per cent over the past decade, bringing it to 50 trillion lire. Moreover, drawings on the facility have been consistently high for many years, in violation of the original purpose of ensuring cash flow flexibility.

Although the problems caused for the economy by the state of public finances spring mainly from the imbalance between the supply of and demand for real resources and must be resolved in that field, the last few years have confirmed the financial benefits that can accrue from management of the public debt. The market in government securities has gained operational viability and depth; in the last two years the average maturity of securities has been lengthened from 15 to 26 months and the responsiveness of yields on floating rate securities to movements in short-term rates has been dampened by changing over to twelve-month Treasury bills as the reference basis. However, during the same two years the public debt rose from 77 to 92 per cent of gross domestic product.

The tender system may be a technically superior way of setting the yield on a particular issue, at least as far as short-term paper offered to professional investors is concerned; however, it is efficient only if issuers avoid imposing constraints on the price and quantity of the issue, as may occur if the floor price is too close to current prices. In the case of Treasury bills, the narrowness of this differential tends to concentrate demand at the floor price, reduces the downward pressure of competition on yields and removes the assurance that the entire issue will be placed. For the same reason, the use of the tender method for Treasury credit certificates, which was introduced in response to the abnormal results produced by special circumstances at the time of the issues in January and February of this year, has not yet brought the hoped-for advantages.

Furthermore, if tenders are to operate properly, the banks and other specialized intermediaries must assess market trends correctly. The freedom of interest rates to move and the ability of market participants to reach equilibrium prices are conditional on one another and must grow simultaneously.

The changes that have occurred in the level and distribution of incomes and the need to reconcile the demands of a multitude of market participants call for capacious and diversified channels of banking intermediation and savings transformation.

For an enterprise, which derives its own profit from the assumption of risk, equity capital forms the very basis of its activity, determines and conditions its scope for growth and enables it to weather the adverse phases of the market. A body of shareholders interested in long-term profits rather than speculative gains is an indispensable backstop for the enterprise. In Italy's experience, reluctance to raise capital in the share market for fear of losing control of the firm has been at the root of crises in companies with good production and marketing but weak finances. It is in the interests of the credit institutions themselves to encourage adequate capitalization in their corporate customers, thereby at one and the same time strengthening the finances of the company, expanding the share market and improving their own assets.

The placement of a greater volume of new share issues depends on increasing the portion of households' portfolios given over to this type of security. There are limits to the expansion in direct sales: most individual savers lack the information and often the ability needed to evaluate offerings, they have insufficient capital to spread their risks and they are unlikely to have any long-term financial strategy. Some form of specialized intermediation is thus essential. In other countries, where individuals have been reducing their direct holdings of shares for some time, abundant equity capital nonetheless continues to flow to firms because institutional investors such as mutual funds and pension funds channel households' wealth into the stock market.

The success achieved by investment funds in their first few months of activity has demonstrated their ability to meet savers' needs. The resources collected by funds with a high equity content open up the prospect of overcoming the shortage of demand for shares. At the end of April their investments in shares amounted to 1 trillion lire.

Reform of the pension system could also generate a substantial flow of funds to the capital market. Pension schemes constitute financial intermediation aimed at transforming current savings into the assurance of future income for those who have reached the end of their working life. In state systems, which are based on the principles of solidarity and support for those on minimum pensions, the need for balance between the benefits promised and the resources invested to generate future income still applies, but the sphere in which that balance is achieved is wider, encompassing the entire economy's capacity for investment and growth. The difficulties with which the pension system is already grappling reflect the failure to comply with this compatibility requirement; they are bound to grow worse and constitute an inescapable problem for the public sector. The development of supplementary schemes that would encourage individuals to acquire pensions commensurate with the contributions they were willing to pay would help stabilize public finances and the economy as a whole by increasing the formation of productive capital.

The existence of a larger body of demand for shares makes it even more necessary to avoid a shortage of supply: more firms must be brought to the stock market. The stock exchange lists do not faithfully reflect the productive system of which they should be a cross-section. Fewer companies are now quoted on the Milan Stock Exchange than in the days of Giolitti, and yet there is no lack of enterprises that meet the listing requirements.

Two years ago we expressed the hope that the banking system, in particular, would establish financial bodies to engage in merchant banking, partly to permit new firms easier access to the share market. Several banks have already joined with other investors in ventures of this kind, thereby demonstrating that they appreciated the improvement this could make to the financial structure of companies and, indirectly, to their own business prospects. They are now waiting for the legal framework of the new institutions to be defined.

The diversification of the financial system, which has seen the creation of new types of market operators and financial instruments in recent years, has raised problems in determining the legal status of intermediaries and defining the necessary requirements for the orderly working of the system.

Developments in other countries have been varied. In some countries, non-traditional financial activity is exempt from specific regulation; in others it is subject to supervision only if it is conducted by particular categories of banks, while in yet others the compass of banking supervision has been widened to include all types of financial intermediation, or provision has been made for a plurality of forms and supervisory bodies.

As far as the conduct of monetary policy is concerned, it may be sufficient if the central bank is given the means to monitor the new forms of saving and credit in the same way as traditional instruments.

However, from the point of view of the stability of the financial system as a whole and the rectitude of financial operations, there is a need not only for an increasing standardization of contracts giving market participants legal certainty, but also for general rules to govern essential aspects of this type of activity. The requirements for intermediaries engaging in such operations, the transactions permitted or prohibited, the information to be disclosed to customers and to the market and the conditions for selling the instruments could be laid down for the specific categories of intermediary involved, along the lines of the law establishing investment funds.

It may also prove necessary to establish prudential supervision for certain types of intermediary, although this will not eliminate the higher degree of risk inevitably associated with saving in forms other than bank deposits. The intensity of supervision and the designation of the institutions responsible for exercising it would depend on the nature of the activity involved.

The credit institutions and the defence of efficiency and stability

Under the influence of the internationalization of financial activities, technological advance and increased competition from other intermediaries, the banking industry is undergoing a transformation that is being encouraged and shaped by regulatory changes affecting the three most significant phases in the life of a banking institution: entry to the market, operational activities and situations of crisis.

The methods employed by the supervisory authorities are themselves designed to increase the banks' independence in decision-making and their sense of responsibility. This does not signify that ultimate power rests with the market. Experience here and elsewhere has confirmed that market forces are not in themselves enough to ensure the efficiency and stability of the credit system; the defence of these characteristics transcends the interests and objectives of individual institutions and requires the involvement of the credit authorities.

The conditions for entry to the banking markets are tending to enhance competition.

Law no. 74 of 5 March 1985 reaffirmed the entrepreneurial nature of banking activities and that the way the Bank of Italy exercises control over entry to the market is through its powers of authorization. The Government has been empowered to apply the principle that entry to the banking sector depends mainly on meeting set objective requirements. When the necessary regulations have been issued, it will be possible to establish new banks in accordance with the criteria laid down in the First Community Directive on the harmonization of banking legislation. A transitional period will smooth the gradual changeover to the new authorization arrangements. The law recently approved, which permits the holders of capital in companies engaging in credit operations to be identified, is an important factor enhancing the transparency of bank ownership.

The regulations on the transfer of bank branches have been liberalized for movements within the same banking centre or market area or to towns not previously served. There is scope for further change in this direction.

The branch network plan that will be drawn up next year will be based on updated information and improved statistical techniques. The results of the market area surveys will be made available to the banks in advance so that they may make their submissions on the basis of more complete information.

The functions of the bank branch as a means of penetrating a local market, establishing personal contact with customers and offering a range of services are being transformed under the pressure of new technology; the changes that are occurring should alert the banks to the need for caution in planning to expand in ways that may create inflexible sources of cost.

The last ten years have seen an intensification in the osmosis of banking systems across national borders. Five subsidiaries of foreign banks are now operating in Italy, with a total network of more than 100 offices. In addition, the number of branches of foreign banks has tripled; today there are 34, with 54 offices. When the abolition of the ceiling on bank lending made interbank operations less attractive, some of the more dynamic foreign banks responded by successfully extending their activities from wholesale banking to the provision of more direct services to customers.

Similarly, the presence of the major Italian banks in foreign markets has also increased; 13 banks are operating 73 foreign branches and own 24 subsidiaries. At the same time, the rearrangement of foreign shareholdings has been completed; without impairing the operational ability of this important and sensitive sector, the links between the various institutions have been rationalized and the institutions themselves brought under the direct control of the parent banks, and hence under the purview of the supervisory authorities. The effectiveness of control will be significantly increased by the bill now before Parliament requiring the consolidation of accounts.

Competition works slowly and unseen on the operations of credit institutions; the potential of the competitive stimuli injected in recent years is greater than their effects to date would seem to indicate.

The banking system is now being compared more harshly with the rest of the economy, particularly as regards the persons selected to serve as directors. However, the personal and professional ability of the banker is thwarted if he is not permitted to exercise his full powers and responsibilities over a clearly defined period. When the terms of office of the boards of the public sector banks are extended for reasons other than the intended purpose of filling temporary vacancies, the sense of security and motivation of directors are undermined, doubt is cast upon the certainty of programmes and policies and the operational ability of the bank is jeopardized.

The success of a banking enterprise is epitomized in the two critical variables of capital adequacy and earning capacity. However, high profitability deriving from particular market positions or a substantial capital base on which the net profits do not provide an adequate return may obscure an unsatisfactory state of affairs.

A comparison between the resources used by the banks and the range of products and services they offer shows that there is room to raise efficiency and to meet the needs of an advanced economy and increasingly sophisticated customers. The credit institutions must take steps to improve both the human and technical resources employed and the quality and variety of their products; the provision of greater information to the public is an aspect of service quality and represents an effective instrument of competition available to the banks.

In many countries, new technology is not only permitting improvements in productivity but is also rapidly changing the payments system, the efficiency and security of which are essential to the soundness of the currency. The banks play a fundamental role in the payments system, one that they cannot renounce. Italy has ground to make up, despite a number of significant achievements. A study prepared recently at the Bank for International Settlements shows that both the new and more sophisticated payment methods and the traditional bank payment instruments are less widely used in Italy than in other countries, partly on account of the habits of the public.

The application of new technology to banking activities raises problems of legal definition, of operational efficiency and security, and of the balance between competition and cooperation. With regard to the last aspect, the desire to prevent the development of monopolies or discrimination against particular sectors of the banking system cannot be carried to the point where the more dynamic banks are prevented from reaping the benefits of their ability to innovate and constrained to adopt the pace of their more reluctant or less efficient fellows.

At a time when innovation and competition are inducing the banks to exploit economies of scale more actively, they should review their corporate strategies in the light of a careful assessment of the prospects in their markets and ascertain in advance where possible difficulties may lie.

Voluntary mergers and cooperation agreements among banks, particularly in the categories where small institutions abound and where closed markets sometimes operate, may simultaneously increase both the stability and the efficiency of the system. The formation of large banking groups in recent years, in some cases as a result of the need to resolve specific problems, has not weakened competition. However, the streamlining of the system cannot be confined to times of emergency.

The simplification of administrative procedures and authorizations for individual operations has not made the central bank any less attentive in monitoring the overall operations of the banks and intervening to expedite the correction of anomalies and malfunctions. Steps in this direction include the new "Supervisory Instructions", which will be published shortly, and the revision of the statistical returns, which will reduce the quantity of data required but improve their informative value.

In response to the request made to the banking system, a group of banks is now beginning to publish uniform data at regular intervals which will significantly enhance the information available on their activities. The public will be able to obtain specific indicators of the soundness, liquidity and profitability of individual institutions.

Reliable data, which depend on adequate internal auditing and accounting arrangements, are essential to the proper working of the market, correct decisions by banks' boards and effective intervention by the supervisory authorities.

In the web of relations between the banking system and the public sector, those relating to taxation have been assuming growing importance.

The tax regime applying to the banks has become more onerous, partly because of the measure relating to the treatment of firms' holdings of tax-free securities; the need for clearer regulations and closer consideration of certain peculiarities of banking activities is therefore becoming all the more urgent. In view of their vagueness, the provisions on the balance-sheet entries for foreign currency assets and liabilities and interest on accounts with foreign banks are open to interpretations that could paralyze the banks' foreign currency operations. By the same token, the possibilities afforded by the present legislation regarding allocations to provisions for bad and doubtful debts cannot be fully exploited. Having to await the formal conclusion of long and complex administrative procedures and bankruptcy proceedings before being able to write off losses that are already certain imposes unwarranted costs on the banks.

The prudential rules and constraints with which the banks must comply, careful preventive supervision and the efforts made to strengthen banks' capital bases are designed to ensure the soundness of the banks and the stability of the banking system and, by extension, to protect savings. This notwithstanding, the closure of institutions that are no longer viable remains an inescapable feature of the banking sector, as of any other industry. In such cases, it is the paramount responsibility of the credit authorities to prevent the crisis of one institution from spreading to the entire system.

Already in the past we have described the inadequacy of the refinancing instruments available to the central bank. In particular, there would appear to be a need to re-examine the guarantees against which the Bank of Italy may grant advances and to broaden the scope for intervention, particularly with regard to banks under special administration.

Experience in Italy and elsewhere led us last year to urge the establishment of new forms of depositor protection to supplement those already in existence. On the basis of the indications we gave, the Italian Bankers' Association has drafted a plan to set up a deposit guarantee fund financed by member banks to intervene in the event of a bank being placed under special administration or in compulsory liquidation. This innovation demonstrates that the banking system can satisfy a widely recognized need of its own accord.

The establishment of the fund does not affect the responsibilities of the supervisory authorities in any respect. The actions that the fund can take will depend on decisions by the credit authorities to ascertain and eliminate the factors at the root of the crisis and, in the event of a collapse, to lay down the terms for disposal of the bank's assets.

In addition, the credit authorities must continue to have a discretionary instrument to protect interests involving the functioning of the banking system itself that cannot be safeguarded by the fund. The need for such an instrument has been confirmed by recent experience in countries that have extensive deposit protection schemes.

Ladies and Gentlemen,

To have brought down the rate of inflation by four percentage points and increased output and investment is an important achievement, not only in quantitative terms but also because it indicates the direction in which we have to move. At the same time, the difficulties and uncertainties of the present economic situation show how the progress achieved so far can be jeopardized by interruptions in the therapy.

Over the years, the country has come to realize that inflation is not an inevitable accompaniment to economic development, that the rehabilitation of the economy need not entail enduring severe crises erroneously supposed to be cathartic, that stability and growth are not mutually incompatible and that they can be achieved once again if policies and behaviour are both directed towards that end. When that has been the case in the past, economic variables and expectations have been swift to react positively.

Squeezed between the appreciation of the dollar, the expansion in the public sector borrowing requirement and the rise in nominal incomes, the central bank took action to defend the currency while paying heed to the state of the economy and the need to strengthen the financial system, which must gear itself increasingly towards sustaining investment and growth.

The criticism sometimes made that central bank policy is excessively severe or permissive is refuted by the fact that the slowdown in inflation has been accompanied by a revitalization of the business sector, not a weakening. Today, funds are no longer being raised to cover losses, as was often the case a few years ago, but to finance investment and production.

The budget imbalance remains serious. It is here that the central bank's room for manoeuvre is restricted and where it is becoming difficult to reconcile monetary control with financing of the deficit. The risks associated with the accumulation of public debt disappear if the budget is balanced; it is budget measures that must be taken to break the vicious circle of debt and interest payments.

The economic outlook has been darkening in recent months. Growing difficulties are looming in the field of public finances, and incomes policy has lost momentum. We have come to a halt in mid-stream and are in danger of drifting backwards. It is crucially important that economic policy be brought back on course.

The most worrying signs are those emerging in the behaviour of prices and the deterioration in the balance of payments. It would be shortsighted of us not to realize the fundamental link between inflation and the ability to hold on to our markets abroad; we would be deluding ourselves if we believed that devaluation of the currency could be a valid substitute for cost and price discipline. The link between the external constraint and economic growth is no less crucial; the imbalance that develops in Italy's foreign trade as a result of even a modest expansion in domestic demand constitutes a serious threat for the future.

Easing the constraints on the country's growth potential requires a considerable commitment; a highly civilized nation should, above all, have the courage to submit to self-imposed rules and limitations in giving effect to the right to work that is enshrined in the Constitution.

The path ahead is still arduous, but there is an increased awareness that the fundamental problems cannot be evaded; the objectives have been defined and are widely accepted.

It is our duty to persevere in the action we have begun in managing the currency and the exchange rate; support from other policies will enable Italy to make further decisive progress towards growth and stability.