BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY 1986

THE GOVERNOR'S CONCLUDING REMARKS

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For several years central banks have operated in an economic environment that is evolving rapidly and sometimes turbulently, at both the domestic and international levels. They have been and still are faced with exchange, money and capital markets characterized by more intense activity and profound changes, which are reflected in the mobility of capital, exchange rate fluctuations, the level and volatility of interest rates and new forms of intermediation.

Sophisticated networks linking financial intermediaries, markets and customers, clearing techniques not requiring the actual transfer of traded securities and new settlement instruments that replace traditional ones are revealing new possibilities in payments systems, in financial transactions and in treasury management by banks, firms and public authorities.

These developments require the Bank of Italy, no less than the entire credit system, to make continual improvements in the way in which it fulfils its institutional responsibilities. The workload has increased in each of the functions it is required to perform, be it monetary and foreign exchange policy, supervision and intervention in the credit sector or the provision of financial services. The staff of the Bank has risen to this increased challenge.

The Bank is called upon to do even more — to combine these distinct yet inseparable functions, to exploit the positive aspects of market developments while containing the potential causes of instability, and to carry out cogently and effectively the market operations and administrative actions for the management of money and credit.

Both at the Head Office and in the branches, there is a growing need for sound and at the same time adaptable professional skills in the economic, legal and technical fields, for managerial and executive ability and for reliable but flexible patterns of organization.

Constant attention and considerable resources are being devoted to staff training. In this effort we are guided by the conviction that the distinguishing mark of the staff of a modern central bank is to be found in the balanced combination of basic interdisciplinary training and specialist knowledge and experience.

Assessment and recognition of the various levels of responsibility are indispensable, with staff being selected on the basis of merit.

Special attention was paid last year to matters involving automated data processing, with steps being taken to integrate the organizational and data processing functions more closely. The preparatory stage of the work associated with the introduction of the "New Lira" was completed.

In April, agreement was reached with the trade union delegations on staff pay and conditions for the three-year period from 1985 to 1987. The negotiations, which opened the round for the credit sector as a whole, were protracted, complex and occasionally bitter, but a positive conclusion was eventually reached. During certain stages of the discussions the operations of the Bank's departments and branches were disrupted, suggesting the need for a code of conduct that would achieve a better balance between trade union rights and the obligations associated with service to the community.

The agreements that were reached are designed to satisfy three requirements, namely to enhance the Bank's ability to perform its functions by setting professional competence and efficiency above automaticity, to go further towards satisfying trade union requests for information on planned organizational and technological innovations with a general impact on working conditions and to make significant improvements in staff pay and conditions, while adhering to the limits on salary increases set by national economic policy. Implementation of the agreements is now incumbent upon the Administration and the staff as a whole.

The world economy

The rate of growth in the industrial economies was almost halved last year; the pronounced slowdown in the United States was not offset by faster growth in the other major countries. The expansion in the European economy continued to be less vigorous than in similar stages of past cycles and investment remained sluggish. The growth in world trade fell from 9 to 3 per cent and the elasticity of trade with respect to economic activity returned to the low levels of the early eighties. The current account imbalances of the three major industrial countries became more pronounced: in the United States the deficit rose to a record $118 billion and the country became a net debtor for the first time in more than seventy years; Japan's surplus rose to $49 billion and Germany's to $13 billion.

Unemployment remained below 3 per cent of the labour force in Japan, while in the United States it fell to 7 per cent, after having touched 11 per cent at the end of 1982. In Europe, however, it is still around 11 per cent, despite the slow growth in the supply of labour and the progress made in narrowing the gap between wage and productivity growth in recent years; together with sluggish aggregate demand, the labour-saving nature of investment continued to play an important role in this respect.

The most positive aspect of economic developments in the main industrial countries was the further reduction in inflation; in 1985 the increase in consumer prices fell to 4 per cent, less than at any time for twenty years, and the wholesale prices of industrial goods rose by 2 per cent. The dispersion of inflation rates around the mean narrowed.

In most industrial countries the trend in industrial unit labour costs continued to favour the slowdown in inflation; in Germany, Japan and the United States they increased by less than 2 per cent. The dollar prices of raw materials were also a significant factor, with those of non-oil products falling by a year-on-year average of 12 per cent and oil prices by 4 per cent. Since the dollar export prices of manufactures rose by 1 per cent, the terms of trade of primary products deteriorated further, falling to their lowest level since the Second World War. Over the years, the effect of factors tending to reduce the demand for primary products, such as the use of technologies with a lower raw material content and the reduction of inventories as, a result of high real interest rates, has been compounded in some sectors by an expansion in supply, particularly in that of agricultural products.

The fall in inflation in industrial countries to the levels of the fifties and sixties is the result of economic policies dating from the early eighties aimed at correcting the root causes of the problem; these have led to reduced dependence on oil (the decisive factor in the breakdown of the OPEC cartel), increased resource mobility, more flexible production methods and a weakening of the mechanisms that severed the link between wage growth and productivity.

There are therefore grounds for hoping that the Great Inflation is over; the challenge now is to return to a growth path of full employment combined with price stability.

At the beginning of 1986 the world economic scene was altered by the accelerated decline of the dollar and to an even greater extent by the collapse in oil prices, which fell by over 40 per cent in the space of a few weeks. Although the impact of these developments on individual countries and regions will differ substantially, for the world economy as a whole they should be conducive to stronger growth, a reduction in unemployment and an easing of the financial strains that have accumulated over more than a decade.

The gradual weakening of oil prices had been due to success in energy conservation and the development of alternative sources, but the price collapse that occurred in January was caused to some extent by temporary factors and may therefore be partly reversible. Uncertainty is heightened by events such as the accident that occurred at a nuclear power station a few weeks ago.

Scenarios constructed by international organizations on the assumption of an average oil price of around $15 per barrel suggest that the oil receipts of oil-exporting developing countries will fall by $70 billion in 1986 and those of planned economies by $5 billion. Developing countries that are net oil importers should enjoy a reduction of more than $15 billion in their energy bill; in some of them, part of these resources will probably be used to improve their external financial position and will therefore not translate into higher imports. The demand stimulus required to offset the reduction in imports by oil exporters and to allow world trade to grow will have to come from the industrialized countries, which are expected to save some $60 billion as a result of the fall in oil prices. Growth in the industrialized world is expected to increase by more than one percentage point over a two-year period and inflation to fall by between 2 and 2.5 points. The growth in real incomes associated with the slowdown in prices should sustain demand and help hold down wage demands.

Recent economic data indicate, however, that realization of the growth potential created by the fall in oil prices is proceeding slowly. It is essential that economic activity should accelerate in the countries that have defeated inflation and have substantial balance-of-payments surpluses on current account. Conditions are also favourable to a continuation of the fall in interest rates.

The economic policies of the industrialized countries must also take account of longer term considerations. Oil remains a basically scarce commodity; too rapid a resumption in energy consumption and a relaxation of efforts to conserve energy and develop alternative sources would jeopardize the progress made so far and might lead to a rebound in oil prices.

A turning point was reached in the foreign exchange markets in 1985. The upward trend in the dollar exchange rate was reversed and the attitude of the United States changed with regard to the external value of its currency. The gradual depreciation of the dollar began in February, induced by interventions by European central banks, including the Bank of Italy. In early September, signs of upward pressure on American interest rates seemed to foreshadow a renewed appreciation of the dollar. On 22 September the authorities of the five leading industrial countries therefore publicly announced that they had decided to bring about a fall in the dollar exchange rate by various means, including concerted intervention. Their action, in which Italy participated significantly, was immediately effective, partly because it came at a time when changes in the dollar trend were expected and the US balance of payments on current account was clearly in disequilibrium. In the months that followed, the depreciation of the dollar was consolidated by the worsening of the current account deficit and the easing of monetary conditions in the United States, as well as by changes in short-term interest rates made in concertation with the other leading countries.

The dollar has now declined against both the yen and the Deutschemark by almost 35 per cent from the peaks recorded in February 1985; if the other currencies and the composition of US foreign trade are taken into account, the effective depreciation was less, around 25 per cent. In real terms, the dollar exchange rate is now close to the levels recorded in the three years from 1980 to 1982, when the US current account was broadly in balance.

The burden of correcting the balance-of-payments disequilibria between the three leading economies cannot be allowed to fall wholely on exchange rates, which are slow to influence trade flows; this task should now be performed primarily by coordinating aggregate demand policies.

Given the present state of integration of the foreign exchange markets and the high mobility of capital, the exchange rates of the major currencies are influenced predominantly by financial variables and expectations. They can therefore overreact to actual or expected changes in monetary and fiscal policies, with potentially adverse repercussions on trade in goods and services. The stabilization of exchange rates and expectations therefore calls for monetary and fiscal policies to be carefully dosed and coordinated at international level. Beyond the short term, consistency between the macroeconomic paths of the leading countries must be restored in order to eliminate the structural disequilibria between saving and investment.

Whereas structural balance-of-payments surpluses depress the underlying rate of growth of the world economy, cyclical variations in demand, especially in the United States, cause fluctuations in exchange rates, external accounts and international liquidity. Large shifts in exchange rates give rise to fresh real economic shocks and trade friction, jeopardizing international adjustment and growth.

Overall, the European Monetary System stood up well to the repercussions of the fall in the dollar; signs of strain appeared only when the dollar depreciation became too rapid. The adjustment of the central rate of the lira was carried out in July, when there were no pressures in the European exchange markets. The general realignment of rates, which was prevented on that occasion by non-economic factors, was carried out in April of this year.

Cooperation among the central banks participating in the EMS was effective in preventing and counteracting strains, particularly during the fall in the dollar, when interventions in Community currencies might have conflicted with those in dollars. The mechanism for mobilizing official ECUs was activated for the first time; intervention in the private ECU market, which various central banks have been undertaking, albeit on a small scale, was recognized to be useful; and proposals that will permit a link between the official and private ECU markets, which are currently separate, are now under examination.

The developing countries were adversely affected last year by the deterioration in their terms of trade and the slowdown in imports by industrialized countries. The situation was exacerbated by the reduction in lending from private and official sources. The depreciation of the dollar, the decline in international interest rates and the fall in the price of oil have brought an improvement in the overall position of debtor countries, but the situation has become more difficult for those that are net oil exporters.

The growing disparities in conditions in the countries involved lend weight to the view that the external debt problem should be tackled by using measures and instruments tailored to the situation in individual countries while still conforming to uniform general criteria. At the same time, these countries must have a genuine prospect of growth and of an easing of their external financial constraints. The plan put forward by the US Treasury Secretary offers a useful framework, on account of the attention it pays to a resumption of growth, the willingness it displays to provide international support and its recognition of the global nature of the problem. However, implementation of the plan is proving difficult.

The debtor countries must be ready to draw up adjustment plans in collaboration with the Bretton Woods institutions. The scale of capital flight underlines the crucial need to restore confidence at home. The monetary stabilization programmes of Argentina and Brazil demonstrate that awareness of this need is spreading.

It is the duty of the industrial countries to create a climate that will stimulate an expansion of demand and world trade and promote financial stability. The Paris Club will continue to make a substantial contribution to easing the burden on the debtor countries by renegotiating official loans. Another important step is the commitment to give favourable consideration to the resumption of official credit guarantees for exports to debtor countries that implement the necessary adjustment programmes, as was reaffirmed at the recent meeting of the Interim Committee of the IMF.

The operational capacity of the World Bank should be strengthened by agreeing on the general increase in its capital and replenishing the resources of the International Development Association. The World Bank should devise intervention techniques better tailored to the need for structural adjustment of external positions and should strengthen its cooperation with the IMF in the formulation of macroeconomic policies and structural measures.

The commercial banks, which have recognized their specific interest in resolving the problem, have undertaken in principle to grant fresh loans; the amount and cost of such funds will have to take greater account of the progress made by debtor countries in restoring external equilibrium.

International cooperation has been effective in coping with crisis situations in recent years, but it has failed to bring about substantial improvements in the system of exchange rates and international liquidity regulation.

The recent initiatives to stabilize the exchange rates of the major currencies signaled a return to closer cooperation. The Interim Committee of the IMF has endorsed some of the suggestions made in the Group of Ten report on the functioning of the international monetary system; it has identified the introduction of procedures for the multilateral surveillance of economic policies in the major countries as the first step towards improving the system. The criteria and techniques for detecting divergences in national economic policies are being defined. The potential contribution of the SDR in making the supply of official reserves more stable has been acknowledged.

These views were confirmed and given fresh impetus at the recent meeting of the Heads of State and Government of the major countries; they constitute the first steps towards a more closely managed system of exchange rates and international liquidity. Further advances, including target-zone mechanisms, cannot be achieved until the serious balance-of-payments disequilibria of the major countries have been corrected. Awareness of the limitations of the current initiatives and of the difficulties that stand in their way should not discourage efforts to achieve fundamental improvements in the system.

In Europe, the curbing of inflation, the reduction of external deficits and improved prospects for growth are creating the conditions for a resumption of the process of integration.

With the Single European Act of last December, the European Council has endorsed the objectives contained in the White Paper of the Commission of the European Communities on the internal market, which proposes the gradual dismantling of the barriers that still impede the free movement of goods, capital and labour and thus block the creation of a market of continental dimensions on which firms can base their investment and expansion plans. At the same time, the principle of majority voting has been introduced for the most important decisions concerning these matters, which had previously required unanimity. The complete unification of markets will be a test of Europe's ability to advance and that of individual countries to participate in this development.

The Italian economy and monetary and exchange rate policies

In recent months the Italian economy has been benefiting from the decline in the dollar and the fall in oil prices, an opportunity to ease the constraints on balanced growth that must not be missed.

The events of 1985 demonstrated the force of these constraints. Though confirming the renewed strength of the economy, the overall results for the year were less impressive than had been expected.

Gross domestic product grew by 2.3 per cent, equalling the European Community average and creating a hundred thousand new jobs, but the expansion was not robust enough to prevent a worsening of unemployment,, which is increasingly concentrated in the south of Italy. For the first time in thirteen years inflation fell below 10 per cent for the year, but it was still two points above target, while Italy's four-point inflation differential with the rest of the Community narrowed only slightly. The twelve-month inflation rate remained virtually unchanged with respect to December 1984. The state sector borrowing requirement amounted to 16.1 per cent of GDP, as compared with the target of 14.4 per cent. The balance of payments on current account recorded a deficit of 8 trillion lire as against 5 trillion in 1984, despite an improvement in the second half of the year.

Over the year, the expansion of the most significant aggregates for the conduct of monetary policy was relatively close to the targets set in September 1984 and confirmed in February 1985. Credit to the private sector expanded by 13 per cent as against a target of 12 per cent. Total domestic credit, including government borrowing, increased by 18 per cent instead of the 16 per cent planned. The money supply grew by 11 per cent, compared with a target of 10 per cent. All these figures were distorted by exceptional events that occurred towards the end of the year, to which I shall return later.

Independently of the performance of the real and monetary aggregates, the persisting disequilibria, particularly those in public finances, leave the economy exposed to latent instability that emerges as soon as fiscal and incomes policies are eased or falter; there is a growing risk that inflation will be rekindled by the pressure of expectations on aggregate demand, domestic costs and the exchange rate.

In 1985 the risk materialized twice, once in the spring and again towards the end of the year. On both occasions monetary policy had to be tightened to contain the danger.

Early in the year, the high exchange rate of the dollar drove up the lira prices of raw material imports. The expansion of exports to the United States was not enough to offset weak sales in other markets. In Europe, the declining competitiveness of Italian products combined with stagnant demand to hold down export growth. In the first half of the year growth in export volume came to a halt.

The stagnation in foreign demand was offset by an expansion of domestic demand. Investment in machinery and equipment remained buoyant. Expanding consumer expenditure was fueled by rising disposable income, stemming largely from government transfer payments. Increased import volume and higher import prices combined with the slowdown in exports to produce a worsening deficit on the external current account.

Any downward adjustment of the lira's exchange rate within the EMS prior to the expected depreciation of the dollar would have unleashed new inflationary pressures and was in any case hardly feasible during the protracted weakness of the Deutschemark. Indeed, during this phase Italy had had to make substantial intervention purchases to prevent an appreciation of the lira.

With the reversal of the trend of the dollar, a downward adjustment became possible. This met the need to regain international competitiveness after the erosion caused by differential price movements since the previous realignment in March 1983. The rigorous exchange rate stance which we have adopted within the EMS to curb inflation and encourage firms to take lasting cost-cutting measures would lose its efficacy if there were no provision for making adjustments when the point is reached at which disadvantages outweigh advantages. In late February and early March the lira was allowed to slip from the upper to the lower part of the EMS band of fluctuation.

During those months, the budget deficit diverged from its appointed course. Financing it by securities issues at the prevailing interest rates became a problem. In March the Treasury borrowing requirement amounted to 13.4 trillion lire, but there was a sharp fall in demand for government securities. The Treasury drew almost 5 trillion lire on its current account with the Bank of Italy, reaching its overdraft limit, even though the latter had increased by 6.9 trillion lire in January. For the first six months of the year the state sector borrowing requirement was 40 per cent larger than in the first half of 1984.

In the spring, uncertain expectations during the run-up to the local elections and the referendum on the *Scala mobile* were combined with the risk of a surge in domestic demand triggered by public spending and fueled by the heightened liquidity of the economy. The monetary aggregates were expanding faster than planned. Thanks to the improved situation of firms, financing to the productive sector was within the target range. However, the expansion of the banks' net external indebtedness, which had exceeded the set limits, gave grounds for concern.

Non-monetary financing of the public sector borrowing requirement necessitated an increase of almost one point in yields on government securities in April. The monetary and credit aggregates were brought more closely into line with the targets, partly by means of securities repurchase agreements and warnings to the banks to respect the ceiling on foreign indebtedness.

Measured in relation to December 1984 and on an annual basis, the pace of expansion in monetary base slowed down from 16 per cent in May to 12.5 per cent in July. The growth differential between total financial assets and the money supply, which had prevailed for the previous five years but had almost disappeared in the early part of 1985, re-emerged in the summer. By contrast, total domestic credit continued to expand faster than the target owing to the pressure of the public sector borrowing requirement.

Once the inflation risks associated with expectations and domestic demand had been averted, Italy was able to restore its competitiveness by adjusting the central rate of the lira within the EMS in July.

The realignment preempted market expectations and came at a time when the depreciation of the dollar and the fall in commodity prices on world markets kept the inflationary impact to a minimum. The recovery of economic activity in Europe, and especially in Germany, widened the scope for improving Italy's trade balance.

I have commented on another public occasion on the dollar quotation at the fixing of 19 July and the conduct of the Bank of Italy in this regard. The detailed scrutiny to which these events have been subjected has confirmed that the Bank acted correctly.

In the second half of the year, exports recorded a volume increase of 13 per cent on an annual basis while import growth slowed down, partly owing to a pause in the expansion in domestic demand. The rate of increase in consumer spending remained broadly unchanged. Investment in plant and machinery declined, after having expanded by 40 per cent in real terms in the space of two years.

The Bank of Italy maintained tight control over the monetary base in order to complete the correction of the monetary aggregates and complement the exchange rate adjustment. In September, a reduction of more than half a percentage point in deposit rates helped to widen the differential between yields on Treasury bills and those on bank deposits. In October, the banks' liquidity fell to the lowest average daily level since the beginning of the year, turning negative net of fixed term advances and securities repurchase agreements.

The dollar began to depreciate sharply as a result of the agreement among the five leading industrial countries on exchange rate intervention policy; Italy participated in the concerted action, with market sales of $1.7 billion from its reserves between 23 September and 3 October.

The rise in wholesale prices slowed down. Italy's external accounts improved and the fall in import prices offered new scope for reducing inflation. The incipient fall in oil prices on international markets became more pronounced.

The success of its auctions enabled the Treasury to reduce the yield on bills by about half a percentage point in October, bringing the average rate down to 13.27 per cent.

These developments made it possible to continue easing the restrictions on foreign payments and led to a reduction in the official discount rate and the rate on advances from 15.5 to 15 per cent on 7 November.

Business sentiment changed abruptly in the last week of November. A foreign exchange crisis broke out, which lasted for thirty trading days from then until the middle of January and proved to be one of the most serious of recent years.

There was a widespread conviction that the lira would be devalued again; a number of factors may have helped form this impression. Expectations of further imminent realignments of Community currencies were aroused by the strengthening of the Deutschemark and reinforced by official statements from some of the countries belonging to the EMS. Domestic factors may also have played a part; the implementation of budget measures to complement the July realignment of the lira had been delayed, the passage of the

Finance Law was proving laborious and negotiations between trade unions and employers on labour costs had been broken off.

In the last five trading days of November sales of foreign exchange by the Bank of Italy were running at a daily average of more than $150 million. The forward discount on the lira soared, prompting the repayment of foreign borrowings. The outflow continued at a rapid pace throughout December and the first two weeks of January, causing a reduction of $5.3 billion in the foreign exchange reserves.

Given the structurally high degree of liquidity in the economy, the sudden decision by businesses to reduce their foreign liabilities had repercussions on the banking system; in December, when economic activity was no more than moderate, lending in lire rose by 15 trillion lire; on a seasonally adjusted annual basis the rate of growth reached 60 per cent, while the twelve-month rate rose to 22 per cent. The increasing expense of recourse to the Bank of Italy was not reflected in the cost or volume of bank lending.

To have given way to market pressure would have been to endorse adverse expectations of the external and internal value of the lira that were not justified by the state of the economy. The subsequent use of exchange rate management for purposes of economic policy would have been jeopardized and the benefits to the trade account would have been small compared with the cost of higher inflation. The July realignment had restored Italy's price competitiveness to the level of mid-1983. The profits and financial situation of industrial firms, particularly large companies, provided them with room for manoeuvre. An improvement in the balance of payments on current account had been evident for some months and could be expected to continue in 1986 in view of the decline of the dollar and the fall in oil prices. A failure to stand firm would have prevented the downward trend in the cost of imported primary and intermediate products from feeding through into domestic prices.

The exchange rate had to be maintained if the improvement on the cost front was to benefit the fight against inflation.

The foreign exchange reserves constituted the first line of defence in their unique role as an instrument for giving the market time to assimilate actual and potential improvements in the balance of payments and price trends. Since the desired change in expectations was slow to materialize, it was decided in mid-January to take action on three fronts, namely to raise interest rates on government securities, to reintroduce the ceiling on the growth in bank lending in lire until June and to require export credits to be financed in foreign currency.

These measures were supplemented by tightening the restrictions on the availability of bank liquidity and, above all, raising its cost, although the effect was partly offset to prevent the flow of funds abroad from placing intolerable strains on the payments system.

Central bank refinancing increased by 5.8 trillion lire in December to stand at nearly 9 trillion lire, but the high level of banks' reserves was more apparent than real. Some of these funds became inaccessible when strikes by Bank of Italy staff closed the clearing accounts at the end of November. Net of borrowing from the central bank, the credit institutions' liquidity was decidedly negative over the month as a whole.

Taken together, these exceptional events strongly affected the monetary and credit aggregates; in particular, figures on the monetary base show an increase of almost 15 per cent between the beginning and the end of 1985. The stringency of the tightening towards the end of the year can be gauged from the rapid rise in short-term interest rates. The average cost of new advances granted by the Bank of Italy in various forms rose by two percentage points between the beginning of November and the end of December and by almost a further point in January, reaching 19 per cent in the case of securities repurchase agreements. Overnight interest rates rose even more sharply.

The measures taken in mid-January had an immediate effect on expectations. The foreign exchange reserves that had been sold during the crisis were repurchased with no gain to traders.

The improvement in the general economic climate made it possible to resume the reduction in interest rates at the end of February. From March onwards, the decline spread from short and very short-term rates, where the increase had been most pronounced, to longer-term government securities.

Three one-point reductions in the discount rate and the rate on advances were made on 21 March, 24 April and 26 May, bringing both rates down to 12 per cent.

The yield at issue on twelve-month Treasury bills fell from 13.35 per cent at the beginning of February to 10.96 per cent in the most recent auction; that on four-year Treasury bonds decreased from 13.33 to 10.33 per cent on the current issue. The banks' net liquidity gradually recovered, becoming positive in April, owing partly to the resumption of inflows of capital from abroad. The constraints imposed by the lending ceiling sharply curbed the speculative element in lending in lire, which was brought back to the level considered appropriate for financing the projected growth in economic activity.

In April the decline in bank interest rates resumed, with deposit rates falling more markedly than lending rates, which had decreased by 2.3 points during 1985 in the wake of the fall in money market rates. The restrictive measures taken in January had caused a rise of almost one point; this was reversed and the downward trend set in again.

With the foreign exchange crisis over, Italy was able to arrive at the realignment of EMS central rates, which had been requested by France on 4 April following the French parliamentary elections, in a satisfactory monetary and foreign exchange condition free of immediate strains.

The decision to pitch the central rate of the lira mid-way between the appreciating Deutschemark and the depreciating French franc was the most appropriate way of reconciling the two objectives of reducing inflation and restoring balance-of-payments equilibrium. It was consistent with the policy followed during the exchange crisis at the end of 1985, and its validity was confirmed by the behaviour of the lira in the foreign exchange markets and by the inflow of reserves.

A week after the realignment, the restrictions on capital movements that had been imposed in January were removed and new measures were taken to liberalize external financial transactions.

On the inflation front, expectations turned downwards, and were reinforced month after month by the actual inflation data. The wholesale price index declined in both February and March, so that it now stands at the level of twelve months ago. The fall in raw material prices has not yet carried over into the trend of manufactures prices, which seems so far to reflect greater concern for profitability than competitiveness; in March the prices of manufactures were 1.4 per cent higher than in December and 6.1 per cent above the level recorded in March 1985. The slowdown in the cost of living has resumed; after a long pause at 8.5 per cent, its twelve-month rate of increase fell to 6.3 per cent in May.

In February the trade balance began to reflect the decline in the lira prices of oil and oil products. The surplus on trade in non-energy merchandise also increased. Economic activity is expanding, sustained by domestic demand, and there are signs of a recovery in fixed investment following the pause in the second half of 1985.

The size of the state sector borrowing requirement remains the principal cause for concern. Over the first four months of 1986 it amounted to 40 trillion lire, as against 38 trillion in the same period of 1985. To cover new financing needs and renew maturing securities, government issues will have to average 32 trillion lire a month for the rest of the year. Should even a tenth of that amount fail to be subscribed, the consequent Treasury drawings on its overdraft with the Bank of Italy would cause bank liquidity to approximately double, once again raising problems of monetary control.

The return of normal liquidity conditions and market sales of securities to cover the state sector borrowing requirement made it possible to cut the twelve-month rate of expansion in the monetary base to 10.3 per cent in January and 9.4 per cent in April. Though the growth in the money supply and credit to the corporate sector accelerated in April, it remained in line with the targets.

Monetary policy continues to have little room for manoeuvre. Financing a rapid acceleration in the growth in economic activity could come into conflict with the present trend of the public sector borrowing requirement. Monetary and credit aggregates will continue to be monitored closely, especially during the phasing-out of the ceiling on lending, to permit prompt correction of any excessive expansion.

An evolving financial system

The Italian financial system is undergoing a transformation that both mirrors similar developments abroad and reflects features peculiar to the Italian economy.

The transformation started with the money market. Its modernization, which began in the mid-seventies, created the technical conditions for more effective monetary and exchange rate policy and more diversified financing of the budget deficit. Participation in the European Monetary System involved a tightening of domestic monetary and credit policy.

Firms have come under strong pressure to implement rigorous reorganization programmes to regain their vitality. The conflict between the growing volume of resources absorbed by the public sector and the need to restore price stability and prevent unsustainable balance-of-payments deficits was a contributory factor in the rise in real interest rates to a very high level.

The imbalance in the state sector's finances has its roots in the deficit net of debt interest, which rose from 6 to 7 per cent of national income in 1985. The very real difficulty of reducing this deficit sometimes leads to schemes being conjured up for cost-free adjustment of the public finances. Underlying these schemes is the idea that it is sufficient to reduce the portion of the deficit corresponding to the interest burden.

Determined efforts to curb the interest burden will, of course, have to continue, but the problem of public finances will not be solved unless the flows causing the budget deficit to expand are stemmed at source. Adjustment will require concurrent action to curb both components of the deficit.

When proposals for compulsory reductions in interest rates are put forward, it appears to be forgotten that the amount of savings the state can attract to finance its deficit spending is not fixed but varies with the yield and risk conditions offered. If the government uses its power of fiat to worsen these conditions, or provokes fears that they will worsen, it makes borrowing more difficult and in the long run more costly.

The government's financing needs are now so large that such instruments as the banks' securities investment requirement have also been blunted. Even on the unrealistic assumption that banks had to invest all new deposits in government securities, only a small part of the borrowing requirement would be covered. For the bulk of its financing needs, the government would still have to turn to a market reeling from the effects of the introduction of the requirement.

The ownership of government securities is very widely spread. The number of custodian accounts households have with banks runs into millions. The value of these holdings tends to be small: at the end of 1985 more than 60 per cent of such deposits with some major banks were worth less than 20 million lire and the average did not exceed 35 million. In addition, the share of government securities held by investment funds and portfolio management services is expanding rapidly. The watchfulness of households and the expertise of fund managers make the market react rapidly to changes in economic advantage.

The Bank of Italy is committed to encouraging the adjustment of interest rates as conditions in the economy change. Both constant dialogue with the Treasury and close collaboration with the banks are fundamental to the achievement of this objective. Over the years the forms of cooperation developed with the major banks — without prejudice to decision-making autonomy — have stabilized the demand for government securities at issue and helped to broaden and steady the secondary market.

Encouraged by high real interest rates, households have expanded their financial investment in recent years and diminished their purchases of real assets, especially housing. Firms have reorganized their operations and restructured their finances, reducing their reliance on external resources.

Although these basic trends persisted last year, new attitudes also emerged. Households began to diversify their financial wealth and firms, especially those of medium and large size, showed greater interest in share issues as a means of raising funds.

The stock exchange was the meeting point of the new attitudes of firms and households. The improvement in firms' current and expected profits together with the better macroeconomic outlook helped trigger a rapid rise in share prices. The index doubled in 1985 and doubled again in the first part of this year before fluctuating wildly in the last few days.

While the direct relationship between the Treasury and savers has been built up over a period of ten years, with the supply of securities tending to exceed the demand, the link between firms and savers has been re-established in a very short space of time, with the demand for shares running ahead of the supply. In 1985 the latter was boosted by share issues of listed companies amounting to nearly 5 trillion lire, by the flotation of new companies and the sale, above all by groups in the public sector, of substantial blocks of shares in excess of those needed to maintain control. This, however, fell short of the rise in demand, attributable notably to investment funds and portfolio management services. The funds have raised 35 trillion lire in less than two years of operation and have invested about one fifth of this in the equity market, but in the early months of this year they became more cautious in the face of the continuous rise in share prices.

The business of the investment funds is subject to statutory and other constraints designed to ensure proper management and risk diversification but not to prevent the danger of over-rapid growth. The Bank of Italy is responsible for seeing that these constraints are respected. Funds' operational policies are the responsibility of their management companies. A farsighted approach, especially for funds that invest in shares, requires a medium-term strategy that will result in consistent policies not only for investment but also for fund-raising.

The prolonged boom in share prices has encouraged listed firms to make large new issues. In the first four months of 1986 these amounted to 3 trillion lire and others totaling over 4 trillion have been approved. There is also scope for sustaining the supply of shares through further partial privatization of state-controlled companies. Credit institutions will also have to make a significant contribution by advising businesses to seek stock market listing when their prospects and size are adequate. Merchant banking, in which some institutions are already allowed to engage, therefore needs to be developed rapidly within a suitable regulatory framework.

The rationalization of market structures, initiated in the last few years with the automation of data processing and the centralized administration of government securities, has continued with the preparation of a book-entry system that will eliminate the physical transfer of certificates in clearing houses. A similar advance will be possible for non-government securities once Parliament removes the legal obstacles to their centralized handling by the body set up for this purpose, Montetitoli. This will not be sufficient, however, unless listed companies and banks rapidly make the preparations needed to exploit the service to the full. At present, the use made varies considerably from one bank to another and is generally small. In the meantime, a non-interest-bearing deposit of 30 per cent of the value of securities not delivered when due has been introduced with the aim of limiting the movement of provisional certificates of title issued by banks and ensuring more orderly settlements.

An efficient capital market helps to improve the allocation of resources and makes it easier for firms to raise funds. Other things being equal, it makes capital cheaper and permits a larger volume of investment to be financed. This is why the shortcomings from which it still suffers need to be eliminated.

The same reasoning holds for the reform of exchange controls and the removal of the constraints on financial transactions with non-residents that had to be imposed in the past. Today, in a situation in which it is proving difficult to achieve the coordination of national policies made necessary by the greater mobility of capital compared with goods and services, liberalization is not without risk, especially for an economy that is still adjusting. Nonetheless, we are determined to follow this path.

The combined behaviour of the Treasury, households and firms is modifying the traditional role of banks. A growing share of saving is being invested in non-monetary instruments; whereas money accounted for over 65 per cent of the total flow of financial assets in 1980, it now accounts for about 40 per cent. The role of the specialized businesses that stimulate and channel flows of savings is growing and competition in the markets is intensifying.

The banking system is reacting to these developments. To a greater or lesser extent all the banks are expanding the range of services they supply and diversifying their activities.

Payments services are particularly suited to the widespread application of informatics. The advance of computers and telecommunications has made data transmission networks an indispensable infrastructure. In view of the leading role they play in the payments system, banks are in a position to exploit all the opportunities offered by the development of technology. A great deal has been done, but there appears to be a need for a quantum leap in both the way and the amount the new settlement systems are used; this calls for fuller utilization of existing systems rather than additional investment in equipment.

Technological innovations are encroaching on the functions of the traditional banking establishment, to the point of replacing it in some operations. The importance of branches is tending to decline and banks' growth strategies are becoming increasingly diversified and flexible. Partly in the light of these developments, credit institutions will be allowed greater latitude once the forthcoming branch plan has been implemented. This new approach has already been adopted in the partial liberalization of branch transfers.

Another way banks can diversify their activities is by setting up legally separate and functionally specialized organizations. The creation of multi-function banking groups is in line with the tendency to decentralize corporate structures that can be seen in other sectors and countries. This enhances the banking system's flexibility and its ability to adapt to the changing needs of the economy, but accentuates the interdependence between companies and sectors, thereby increasing the danger of crisis situations spreading.

With the removal of the ban on the establishment of new credit institutions, the question of how desirable and possible it is to separate banking from industry has come to the fore again. The large proportion of public credit intermediaries in Italy attenuates the problem, but does not eliminate it entirely. On several occasions I have called attention to this issue, which is of more immediate concern today in view of the high level of firms' liquidity. The moral suasion the central bank can exercise may prove insufficient to prevent potentially dangerous situations from developing. A rigorous statutory separation of ownership is feasible, as the example of the United States shows. At all events it is necessary to safeguard banks' independence of their customers in their operations.

Further disintermediation and fiercer competition did not prevent banks from recording generally good results last year and strengthening their capital bases. Notwithstanding a narrowing of the interest margin, the profitability of the banking system was unchanged. The rise in operating expenses was curbed and this was accompanied by a substantial increase in the volume of business per employee. Banks recorded a further increase in their capital and reserves, which rose in relation to customer deposits from 9.9 to 10.6 per cent.

Bad debts increased to 6.2 per cent of total _loans and to nearly one third of capital and reserves, but the pace of the increase was slower. Even though Italian banks' exposure to the most heavily indebted developing countries accounts for a smaller proportion of their foreign lending than the average of the industrial countries, an increase in their provisions appears advisable. To this end it is worth examining the case for such provisions to receive special fiscal treatment along the lines of the arrangements made in other countries.

The positive results achieved by the banking industry in 1985 must not blind us to the difficulties facing a sector that is crucial to the rest of the economy and which will have to adapt and reorganize on a vast scale. Increasing competition is spurring change but it also entails greater corporate risk. Not all banks are equally well placed to succeed. The weaker ones will have to resolve their problems, perhaps even by merging with other banks. The nature of banking requires the evolution of the system to proceed without jeopardizing its overall stability.

By reorganizing their own operations, banks will be able to extend their traditional central role to the modernization of the financial sector as a whole. In this far from easy task they enjoy the full support of the Bank of Italy.

Italian banking law: its permanent features and development

Italian banking law comprises a central core, the Banking Law proper as set out in Decree Law 375 of 1936 and subsequent amendments, and layers of other laws regarding particular categories of banks or specific intermediaries. This stratification of regulations means that a comprehensive and up-to-date presentation of banking law would be valuable; the Bank of Italy intends to promote this aim by publishing a codified edition in the near future.

The fiftieth anniversary of the promulgation of the Banking Law is an additional reason for reflecting on the legal and institutional forms of credit activity. The fact that the order established half a century ago has successfully weathered the profound changes in Italy's economic, financial and banking structures can be attributed to the 1936 Banking Law having identified and adopted the basic principle governing the defence of savings and entrusted the latter's protection to a group of flexible and effective institutions. Several other countries can be seen to have adopted a similar approach in the legal and institutional reforms that they have either already implemented or are preparing.

It is worth briefly recalling these principles and institutions. Because it links a vast number of economic agents over time on a fiduciary basis, financial intermediation — and banking, its nucleus — constitutes a system and involves risks requiring forms of prudential control and a policy for its structure. A correct allocation of resources requires credit institutions to act independently of the other sectors of the economy. The legislative framework within which they operate allows the authorities responsible for governing credit to intervene promptly and flexibly with administrative measures. The exercise of control is entrusted to a single technical body endowed with operational autonomy.

Events over many years and reflection on their economic significance have led to the reinstatement of the view that credit institutions are enterprises that invest and risk their capital, whatever its origin; that this capital is a small fraction of their total resources; that their business is conducted in conformity with decisions for which the directors bear responsibility; and that their basic features are unaffected by whether they are publicly or privately owned.

The development of this view was neither linear nor without its uncertainties. With the spread of investment incentives linked to credit, institutions that had been set up to support the growth of the economy in accordance with market principles were made to operate in a context where priority was given to public aims, thereby impairing the autonomy of management organs in arriving at their decisions. The mistaken approach of bending credit to serve planning policy aims caused lending to some sectors to exceed the amounts consistent with the principle of risk diversification. The ensuing damage affected the institutional order as well as intermediaries' capital. In the second half of the seventies the crises in some large medium-term credit institutions that the rise in oil prices helped to trigger brought this phase to an end.

In recent years there has been a change of course. Legislation is again being based on criteria that enhance the autonomy and responsibility of directors and make the framework for operations more certain. The practice of intervening on a piecemeal, case-by-case basis that was segmenting and ossifying the system has been abandoned. Parliament has approved laws of a general nature that supplement the Banking Law and enhance some of its provisions.

In 1981 the supervision of the medium and long-term credit institutions was put on a uniform regulatory basis and binding restrictions were imposed on their risk concentration. In the same year the Treasury Minister issued directives on publicly-owned banks that confirmed their freedom from external influence and their nature as enterprises exposed to competition. They also provided that the operations of these banks may not be subjected to special restrictions and that they can strengthen their capital bases by raising funds in the market.

It was also felt necessary in this period to strengthen the supervision of banks. This need was recently translated into legislation. Law 281/1985 regulates the identification of the owners of bank shares, giving substance to a principle embodied in the 1936 Banking Law, and provides instruments for revealing potential conflicts of interest obscured by the interposition of nominees. Law 114/1986 implements the Community directive on supervision on a consolidated basis. It empowers the Bank of Italy to obtain information directly about banks' subsidiaries and makes elusion of supervisory controls a penal offence. Parliament is also examining a bill to apply uniform sanctions to banks of all kinds whose lending behaviour promotes the interests of third parties at the expense of the bank's.

The law implementing the Community directive on freedom of entry to the credit market reaffirmed the entrepreneurial nature of banks and formally introduced the "fit and proper person" criterion in the choice of directors.

In addition to these legislative changes, the exercise of the regulatory powers assigned to the credit authorities has been revised. The instruments and procedures of banking supervision have been directed more to increasing competition and enhancing intermediaries' decision-making autonomy.

This approach has been adopted in the Bank of Italy's supervisory activity regarding branches, geographical restrictions on operations, changes in statutes, the raising of capital in the markets and derogations from operational limits. Procedures have been streamlined and the number of authorizations granted by the Supervision Department in relation to individual loans has been reduced by nearly two thirds.

Experience over the years has highlighted the viability and resilience of the Banking Law. These features will continue to make it possible to guide the development of the Italian financial system and the updating of regulations in accordance with the requirements of an open industrialized economy. In the immediate future, intervention will concern primarily three major areas: revision of the regulations governing some sectors of banking; financial innovation; and the internationalization of banking.

Revision of the sectoral regulations appears particularly desirable for savings banks and special credit institutions. The recent reform of savings banks' statutes has prepared the ground for them to use a greater variety of capital-raising instruments, undertake a wider range of operations and clarify the relations between their governing organs. The development of savings banks is hindered by some regulations designed for purposes that have ceased to be relevant and are incompatible with the requirements of competitive banking markets. A comprehensive new law would allow a broad legal framework to be drawn up, leaving the detailed regulations to be established in secondary legislation and the savings banks' own statutes.

The environment in which the special credit institutions operate has changed in many respects over recent years. The costs and dangers of excessive borrowing convinced firms to improve the balance between their equity and loan capital. The shortening of investment time horizons in response to both technological progress and the more pronounced variability of economic conditions has often resulted in the demand for finance being in the no man's land between special credit institutions and banks, thereby highlighting the problem of the relationship between short and longer-term credit. The structure of the Italian credit system rests on the specialization of intermediaries according to the maturities of their operations. If this principle is to be respected, both the short-term lending of the special credit institutions and the medium-term lending of banks will need to be kept within consistent bounds. It will also be necessary to reduce the disparities in the limits on different banks' direct and indirect lending beyond the short term.

The large industrial credit institutions are moving towards a multi-product model, though their principal object remains the financing of firms' growth. Some of these institutions are extending their operations to include the underwriting and placing of corporate securities. The changes that are taking place suggest, firstly, that the ownership of these institutions should be enlarged, with the aim of broadening their strategies, strengthening their capital bases and giving greater play to their assessment by the market; and, secondly, that the extent of state participation in their capital should be reconsidered. The smaller industrial credit institutions also have to decide on changes to their ownership structures and the desirability of mergers. Both these paths could be taken with the aim of enhancing their potential.

The other special credit institutions appear to be hampered by legal restraints on the operational and geographical scope of their business. To some extent these reflect market conditions that have now changed. New guiding principles will have to be formulated, in part by enlarging and unifying the sectors in which these institutions are authorized to operate. Here again, it may well be appropriate to employ secondary legislation, which would also allow the technical forms of these institutions' fund-raising and lending to be modified rapidly.

In recent years financial innovation has been spurred by a wide variety of factors: the explosion of domestic and international debt; exceptionally high and variable interest rates; wide fluctuations in exchange rates; incentives to circumvent constraints; the revision of regulations governing intermediaries; and the opportunities offered by computers and telecommunications. The creation of new instruments, operators and markets is spreading from the world's leading financial centres to the rest of the industrial countries.

Techniques have been developed for unbundling the risk, liquidity, yield, currency denomination and maturity features of financial instruments, which are then packaged so as to be separately negotiable or else reassembled in innovative forms leading to the creation of new securities. A growing share of intermediation now flows through securities markets with a corresponding increase in the share of total intermediation in the form of negotiable instruments.

Analysis of these developments, to which a recent study promoted by the central banks of the Group of Ten countries has contributed, has revealed the benefits of such changes, but also their dangers. In the short term, innovation improves the working of markets, expands the range of instruments available, intensifies competition and tends to reduce transaction costs.

On the other hand, innovation puts the stability of the system at greater risk since it tends to blur the boundaries between the various kinds of intermediary, compound the difficulty of assessing commitments, and lower the quality of assets by allowing prime borrowers greater scope to tap markets directly. We are therefore again faced with the need — inherent in the nature of supervision — to reap the benefits of the new while averting the threat of instability it entails.

In my remarks last year I drew attention to the problems that innovation was already creating for the Italian regulatory and supervisory framework. The network of debtor and creditor positions that make up financial markets is becoming more intricate and is crossing the institutional boundaries between credit institutions and other financial intermediaries.

The connection between raising funds and granting credit is inherent in the notion of credit institutions, which are subjected to specific and particularly thorough controls. This approach, however, fails to encompass operators whose business does not involve such a connection because it is based on only one of the terms. The activities of these operators also need to be regulated and subjected to prudential controls, though these may differ from those applied to credit institutions, or at any rate be less severe.

The introduction of forms of prudential control on non-bank businesses does not remove the substantial differences distinguishing them from credit institutions. Even when their supervision is assigned to the central bank, as in the case of investment funds, they do not have access to lending of last resort. This needs to be understood both by these businesses, which are responsible for the management of financial resources, and by savers, who must be aware that the value of their investments is variable and depends on market developments.

Italian banks have been expanding their foreign business for many years, initially by financing an increasingly open economy and subsequently through the creation of an extensive network of branches and subsidiaries in the leading international financial centres. Of banks' total volume of business, the foreign component — including foreign currency loans to residents — accounts for about a quarter, with foreign establishments contributing about half this amount.

The interpenetration of national markets has led to the emergence of the internationally ramified bank as a new object of supervision. The broader scale of operations requires parent banks to strengthen their internal decision-making and control functions adequately. The supervisory authorities in the major countries have established procedures for mutual cooperation with the aim of making supervision more effective and ensuring that banks are competing on an equal footing. The authorities act on two levels: bilateral control over individual credit institutions through exchanges of information and agreements on how interventions are to be made; and multilateral drafting of regulations and criteria for the supervision of banks' foreign establishments.

The internationalization of banking should be given new impetus by the Single European Act and the White Paper on the Community market, which also foresees the unification of the capital and financial services market by the end of 1992 through a series of directives. Agreements between supervisory authorities and the drafting of legislation, in which Italy participates actively in the Community, will continue to stimulate and orientate the development of the legal framework of financial intermediation. The past has shown that Italy's banking law has considerable capacity both to evolve and to incorporate experience acquired at the international level.

The objectives of economic policy

A modern and efficient credit system is essential for stability and growth. Its contribution will steadily increase as the economy it serves begins to record new successes, measured by the ultimate yardstick of growth in national income and employment.

The public finances are beset by deep-rooted causes of instability. There are still weaknesses and contradictions in the sectoral and geographic distribution of resources, even within the industries that have adjusted the fastest.

Awareness of the need to complete the task of restoring economic equilibrium has grown and has recently been translated into economic policy objectives set forth in important government policy documents.

In recent years, restructuring has been taking place in industry and the parts of the services sector most closely associated with it, although it cannot be said that the process has yet been completed. The economy is a single entity, however, and part of the cost of adjustment has fallen on the budget. It is now time to resolve the problems of the public finances; if this is not done, all that has been achieved so far will be at risk, precisely because the economy is indivisible.

Numerous measures have already been taken, some of them of substance, but they are designed solely to contain the explosion in expenditure implicit in existing legislation. The ratio of public expenditure to GDP has not yet begun to come down.

Implementation of a broadly based policy is hampered by the repercussions that the nature and scale of the necessary measures would inevitably produce in various sections of society. The costs of such a policy would be felt immediately, and in terms of the social welfare function they may appear higher than the potential benefits to the economy as a whole, some of which would not emerge until later.

The depreciation of the dollar and the fall in oil prices are now creating favourable conditions that may reduce these costs. At the same time, the uncertainty about how long the improved external conditions will last accentuates the need for prompt action to achieve the economic policy objectives that have been set.

The improvement in Italy's terms of trade in relation to their average for 1985 is currently estimated to be in excess of 10 per cent, a figure that indicates the scale of the additional resources that are potentially available. Appropriately, priority in allocating the immediate benefits of cheaper oil has been given to sustaining competitiveness, reducing the budget deficit and maintaining the incentive to save energy.

The shift in the terms of trade provides greater latitude for domestic demand to increase without incurring further deficits on the current account of the balance of payments and increasing Italy's already substantial foreign debt; it also creates room for higher investment.

The increase in domestic demand may be close to 4 per cent in real terms in 1986 and exports are likely to expand by a similar amount. National income may rise by about 3 per cent and employment by around 200,000. Despite the fact that domestic demand will grow more strongly than output, the fall in import prices will allow a current account surplus to emerge and will accelerate the decline in inflation.

Realization of the favourable prospects for 1986 will not wipe out the legacy of years of imbalance in the public debt, in industrial capacity, in the labour market and in the competitiveness of the entire economy.

Industrial capacity stagnated or even contracted during the first half of the eighties; in 1985 it was still below the 1980 level. The generation of profits in industry and the improved prospects for growth may trigger an expansion in the industrial base. Since the end of the seventies, the need to improve productivity has meant that the bulk of investment has been made in the centre and north of the country. If the expansion of capacity occurred mainly in the existing industrial centres, the south of Italy would be placed at a further disadvantage. The nation as a whole would suffer serious harm if the additional resources of capital and labour were distributed unevenly across the country.

The shift in the terms of trade cannot permanently alleviate the external constraint. The balance of trade in volume terms is continuing to shift to Italy's disadvantage, creating the danger of substantial trade deficits should the movement in the terms of trade be reversed. Moreover, if the elasticity of imports with respect to GDP continues to be as high over the medium term as it has been in recent years, an increase in exports in line with the expansion in world demand will not prevent the external constraint from again impeding growth. Sustained development therefore requires a significant expansion in domestic supply and a change in its composition coupled with efforts to achieve greater competitiveness and efficiency throughout the economy, including the sectors that are shielded from international competition.

All the proposed public finance measures and the economic policy guidelines set out in the documents mentioned above are directed towards solving these problems; their implementation is now a matter of urgency.

The guidelines laid down for fiscal policy are designed to hold the growth in current expenditure to the rate of inflation, increase capital expenditure in line with nominal GDP and maintain the tax burden at its current level in relation to GDP, though more fairly distributed among the various classes of taxpayer. Efforts to reduce the budget deficit are being concentrated mainly on social security, health care and local authority finances, reviewing the size and nature of transfers to firms and households and overhauling and strengthening the machinery for monitoring payment commitments and ensuring that revenues are available to finance expenditures.

The Bank of Italy's Research Department has conducted simulations for the period from 1986 to 1988 assuming the implementation of such a fiscal policy, an oil price of between $15 and $20 a barrel and an expansion of about 4 per cent in world trade. The link between international developments and domestic behaviour and policies is close and has a decisive influence on the results, and the underlying assumptions are subject to varying degrees of uncertainty. Hence, exercises of this kind should not be taken as forecasts, but nonetheless they are thought-provoking and may help shape the decisions that have to be made.

Over the three-year period, the simulations indicate an average annual growth of 3 per cent in GDP and nearly 4 per cent in domestic demand, an increase in employment at nearly twice the 1985 rate, broad balance on the external current account and a further slowdown in inflation.

With the state sector borrowing requirement declining in relation to national income, output and investment would be stimulated by improved expectations and the lower interest rates that would become possible. The virtuous combination of economic growth, a smaller interest burden and a reduction in the budget deficit net of interest would bring the expansion in the public debt back under control.

The slowdown in inflation would not, however, eliminate the inflation differential vis-a-vis our competitors; this cannot be cured by external factors, which also apply to other countries. The differential stems from the domestic components of costs; though less powerful than previously, they are continuing to make the prices of Italian products rise faster than those elsewhere.

Even an increase in employment on the scale indicated by the simulations would be insufficient to absorb the full rise in the labour force, which will continue to expand significantly until the early nineties owing to demographic factors and rising participation rates, particularly among women.

To eliminate the inflation differential and achieve a larger increase in employment, fiscal adjustment will have to be supplemented by incomes policy. Expanding employment must take precedence over increasing the incomes of those in work. The reduction in costs deriving from productivity gains and the fall in raw material prices must translate into a slowdown in the prices of manufactures, rather than larger increases in wages and profit margins. The improvement in industrial relations is having a significant beneficial effect; the agreement on employment in the public sector led to reform of the *scala mobile* in the private sector as well and the new wage indexation mechanism will pass on inflationary pressures less rapidly. Administered prices and public service charges must be set at a level that promotes disinflation while curbing consumption, particularly of energy, and encouraging investment to expand the supply of goods and services that are in demand.

Provided they are based on appropriately rigorous criteria, both fiscal policy and incomes policy can be slanted in favour of the economy of the southern regions in order to reduce the regional disparities in economic development and contain unemployment. Substantial government resources have already been allocated for the south under the Finance Law and the laws providing for special measures in favour of firms in the south and incentives for young entrepreneurs; they must now be put to effective use. The hoped-for employment effects will not materialize if the social partners have no confidence in the final outcome and the labour market lacks the necessary flexibility. Investment by small and medium-sized local firms would then be impeded, capital would flow less freely to the south and a brake would be put on the movement of albeit small numbers of unemployed towards the centre and north, where there may be a shortage of labour in the not too distant future.

If action were taken on all these economic policy fronts, the easing of the external constraint and the reduction in the public sector borrowing requirement would allow nominal and real interest rates to come down without this conflicting with a policy for money and credit designed to complete the task of eradicating the inflation that has dominated the Italian economy since the beginning of the seventies. The Bank remains firmly committed to this objective.

Ladies and Gentlemen,

The strategy for restoring monetary stability that I outlined a few years ago was rooted in three fundamental principles: a rigorous management of the money supply and the exchange rate, incomes behaviour that paid due attention to macroeconomic compatibility, and the restoration of the budget as an instrument of economic policy. Underlying this formulation was our awareness of the limitations of monetary policy when it has to fight inflationary pressures singlehanded and our conviction that only by taming inflation would it be possible to engender a rate of growth that would have a significant impact on unemployment.

We have dosed the severity of monetary and exchange rate policy in accordance with these criteria, trusting in a pragmatic use of such instruments rather than in mechanical rules, whose limitations have been revealed by the experience of other nations.

The effectiveness of this method has been demonstrated by the fact that it succeeded in curbing inflation during the protracted period of dollar appreciation and unfavourable terms of trade.

Significant objectives on the long road back to monetary equilibrium are now within reach; inflation is receding towards levels only experienced during the years of stability, which were also the years of fastest growth.

External factors are accentuating the slowdown in prices, just as it was external factors that contributed powerfully to the original outbreak of rapid inflation. It is impossible to predict how long the present favourable circumstances will last. The task before us is not just to reap the immediate fruits but to take advantage of the situation to advance at less sacrifice towards the solution of our underlying economic problems.

We have never been among those who considered surrender to inflation unavoidable, and by our actions we have opposed that attitude. Today, an objective assessment of the progress made and of the more encouraging outlook will hopefully avert the danger of euphoria.

Italy's closer involvement in the economic and monetary policy coordination of the leading industrialized countries, which was agreed at the Tokyo Summit, confirms the progress we have made, but at the same time it commits us to renewing our efforts to complete the adjustment of our economy and return to stable growth that would more fully realize the country's potential.

The creation of jobs demanded by the scale of unemployment and its concentration among young people requires an expansion in the industrial base. The change in relative prices to the benefit of manufactures is creating favourable conditions on the cost front; it is primarily the responsibility of firms to translate these into a slowdown in prices rather than increases in nominal incomes, into real investment rather than purchases of financial assets. The credit system must feel that its part in this endeavour is not only to perform the essential task of screening projects seeking finance but also to increase its own efficiency.

The budget must be overhauled and made more flexible if investment is gradually to strengthen without encountering resource constraints. The restoration of sound public finances is rightly at the heart of government policy. The need for action is now urgent in view of the trends that are under way. The increase in the public debt is continuing to outstrip the rise in national income. Rather than falling, the deficit net of interest payments increased in 1985. The reduction in the interest burden made possible by the slowdown in inflation will count for little if it is replaced by other items of expenditure.

A budget that has been reduced to normal proportions in relation to national income, modified as regards the composition of expenditure and restored to its function as an instrument of economic policy is necessary to guarantee stability, balanced growth and social progress.