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Unless indicated otherwise, figures have been computed by the Bank of Italy.

In the following tables:

— the phenomenon in question does not occur;

.... the phenomenon occurs but its value is not known;

.. the value is known but is nil or less half the final digit shown.

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Economic Developments and Policies

THE WORLD ECONOMY AND INTERNATIONAL FINANCE

The world economy is emerging from the stagnation that lasted from the autumn of 2002 to the spring of this year. After a long decline, stock markets began to rise again in March. Real indicators of economic activity improved during the summer, especially in the United States. The easing of international tensions and the adoption of sharply expansionary economic policies were contributory factors.

Economic conditions differ in the various regions of the world. The situation is markedly more favourable in the United States and the emerging Asian countries, while the recovery has been moderate in Japan and weak in the euro area.

In the first three quarters of 2003 world trade grew by 2.5 per cent from the year-earlier period, reflecting lacklustre performance in the first six months. Developments over the medium term could be adversely affected by the outcome of the Fifth Meeting of Ministers of the World Trade Organization in Cancún.

After growing very slowly in the last quarter of 2002 and the first of 2003, US output began to expand rapidly again in the second quarter; it increased by 7.2 per cent on an annual basis in the third.

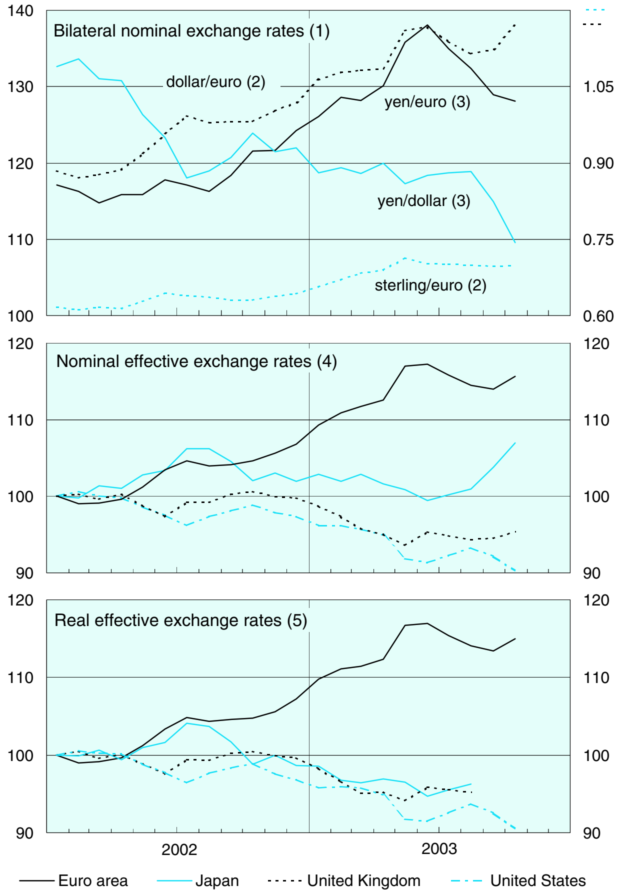
The dollar appreciated during the summer but then began to weaken again in September and the first ten days of October. This trend sharpened after the statement by the finance ministers and central bank governors of the G7 countries at Dubai on 20 September calling for exchange rate flexibility to make a greater contribution to rectifying balance-of-payments disequilibria in the main areas. In the months leading up to the meeting the International Monetary Fund had underscored the need to spread the burden of adjusting the dollar's external value among the currencies of a broad group of trading partners in addition to those in the euro area. Between early September and the first ten days of October the dollar fell by 7.3 per cent against the yen and 8 per cent against the euro; it depreciated less against the other Asian currencies. By 10 November the dollar had recovered partially against the euro. Since February 2002, when the protracted appreciation of the US currency came to an end, it has depreciated by 9.9 per cent in nominal effective terms, while the euro has strengthened by 15.1 per cent and the yen by 8.6 per cent (Figure 1).

In the euro area output growth, which was 0.9 per cent in 2002, stalled in the first half of 2003. The deterioration in the already weak economic situation was mainly due to the further contraction in exports caused by the appreciation of the euro and the slackness of world trade. According to preliminary official estimates, in the third quarter output began to grow again at an annualized rate of 1.5 per cent. On 5 June 2003 the Eurosystem cut official rates by 0.5 percentage points, bringing that on main refinancing operations to 2 per cent.

In the United Kingdom GDP growth, which had slowed abruptly in the first quarter, picked up strongly in the second and third, accelerating to around 2.4 per cent on an annual basis. This was partly due to the upturn in consumption, fueled by expanding household debt. After cutting the official rate on repos by 0.25 percentage points at the beginning of July, on 6 November the Bank of England raised it by the same amount, to 3.75 per cent. In Canada, after growing by 3.3 per cent in 2002, output slowed to 1.6 per cent growth on an annual basis in the first half of 2003 as foreign demand contracted. The Bank of Canada raised its target for the overnight deposit rate by a total of 0.5 percentage points in the spring, then made two 0.25 point cuts on 15 July and 3 September, returning it to 2.75 per cent.

Figure 1

Exchange rates of leading currencies and indicators of competitiveness
(monthly averages)



Sources: Bank of Italy, ECB and Federal Reserve.
(1) Units of the first currency per unit of the second. – (2) Right-hand scale. – (3) Left-hand scale. – (4) Indices, January 2002=100. A rise indicates an appreciation. – (5) Indices, January 2002=100; based on producer prices of manufactured goods for the euro area, Japan and the United Kingdom and consumer prices for the United States. A rise indicates a loss of competitiveness.

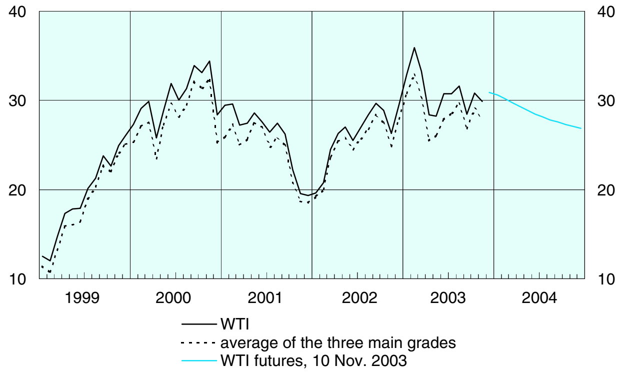
In Japan the expansion under way since in the first quarter of 2002 was more robust than expected in the first three quarters of this year, partly as a consequence of the substantial increase in exports to other Asian countries and the rapid growth of investment. Economic indicators suggest that growth will continue to the end of the year.

GDP growth in the emerging economies in 2003 differed in the various areas. In Asia, after accelerating in 2002, economic activity slackened briefly in the first half of 2003, chiefly as a result of the SARS epidemic. Industrial output picked up in all the main countries of the area from June onwards, signalling a return to faster growth. China's economy grew by over 8.5 per cent in the first nine months compared with the year-earlier period, providing strong support for the area's expansion. In Latin America, where disparities in performance persisted, the economic situation remained sluggish in the first half of the year. However, financial conditions and the climate of confidence improved considerably, laying the foundations for stronger growth towards the end of the year.

After falling at the conclusion of the war in Iraq, oil prices rose from \$25.5 to \$30 a barrel (average price for the three main grades) in the course of the second quarter (Figure 2). Among other factors, the increase was due to expectations of a pickup in world demand and the depletion of stocks in the United States and other OECD countries and, on the supply side, to continuing uncertainty about the resumption of oil production in Iraq and the shortage of spare capacity in the OPEC countries. Prices have fluctuated considerably since September: at the beginning of the month signs that the industrial countries were partially replenishing their stocks and increased production by non-OPEC producers caused

Figure 2

Crude oil: spot price and futures prices (1)
(dollars per barrel)



Source: Thomson Financial Datastream.

(1) For the spot price, average monthly data; for November 2003, the latest available data relates to 10 November. The three main grades are Dubai, Brent and WTI.

prices to drop to $26 a barrel in the third week; the unexpected decision of the OPEC countries on 24 September to cut production beginning in November briefly pushed prices up to $30 a barrel in mid-October; they had eased to $29 on 10 November. The prices of futures contracts on WTI grade oil on NYMEX on that date imply that the price is expected to be the same as the spot quotation of $31 a barrel at the end of the year, before gradually falling to about $27 by the end of December 2004.

The dollar prices of metals, which reflect economic developments most directly, rose steadily from April onwards; in September the 12-month increase was 16 per cent.

Economic developments and policies in the United States

According to the National Bureau of Economic Research, the recession in the US began in March 2001 and ended in November of the same year. The subsequent recovery, which was spurred by highly expansionary economic policies, was discontinuous and generally weak until the first quarter of 2003. Over the next two quarters GDP growth accelerated to annualized rates of 3.3 and 7.2 per cent respectively. In the second quarter the expansion was mainly driven by public spending; over half of the rise in GDP was due to the huge increase in military expenditure. Government expenditure again provided substantial support in the third quarter, with about half the 6.6 per cent surge in private consumption ascribable to the tax relief introduced in May. At the same time the recovery in private investment gained momentum. The increase of 14 per cent was about twice that of the previous quarter; exports also began to pick up, rising by 9.3 per cent (Table 1).

Industrial output began to expand again from the summer, rising by 1.6 per cent overall between July and October. However, capacity utilization, which stood at 75 per cent in October, remains low.

The pickup in economic activity in the second and third quarters was accompanied by moderate inflation. The twelve-month rate of increase of the consumer price deflator excluding the most volatile items remained practically stationary at 1.3 per cent between April and August before edging down to 1.2 per cent in September.

The rate of inflation is expected to remain low in the coming quarters owing to the large output gap, which the IMF estimates at 2.1 percentage points for 2003. The spare capacity will probably be taken up only gradually by the acceleration in economic activity, whose potential growth rate, currently put at just over 3 per cent, continues to be sustained by the rapid increase in labour productivity. In the three years from 2000 to 2002, while output grew by an average of 2.2 per cent, labour productivity in the broad non-farm sector rose at an average rate of 3.4 per cent.

The easing of international tensions, the strengthening of the financial conditions of firms and, from the fourth quarter of 2002, the upturn in profits smoothed the way for a recovery in investment. Growth was especially robust in non-residential fixed investment, which expanded at an annual rate of 7.3 per cent in the second quarter and 11.1 per cent in the third; investment in IT, which had been expanding since early 2002, increased by over 18 per cent in both quarters.

Since the beginning of 2002, reduced borrowing by non-financial firms helped to keep their debt-to-equity ratio stable at around 53 per cent. After six months of moderate growth, profits surged in the second quarter of 2003, rising by 21.3 per cent on a year earlier. This can be attributed to a fall of 1.4 per cent in unit labour costs and 1.7 per cent in the costs of other factors of production. The decline in unit labour costs over the last two years reflects the exceptional rise in labour productivity, which averaged 5.8 per cent in 2002 and 4.3 per cent in the first half of 2003 on the year-earlier period.

Consumption accelerated gradually during the year, expanding by an average of 3 per cent in the first three quarters with respect to the year-earlier period as disposable income increased. Households' financial situation also improved: after the dramatic fall over the previous three years, share prices picked up in the second quarter of 2003, raising the ratio of gross financial assets to disposable income by

Table 1

Economic indicators for the main industrial countries (1)

(at constant prices; unless otherwise indicated, annualized percentage changes on previous period)

	GDP	Household consumption (2)	Government consumption	Investment (3)	Changes in stocks (4)(5)	National demand	Net exports (4)(6)
United States							
2002	2.4	3.1	4.4	-3.1	0.7	3.0	-0.7
Q4	1.4	1.7	4.6	4.4	0.3	2.9	-1.6
2003							
Q1	1.4	2.0	0.4	-0.1	-0.8	0.6	0.8
Q2	3.3	3.8	8.5	7.1	-0.7	4.4	-1.3
Q3	7.2	6.6	1.3	14.0	-0.7	6.0	0.8
Japan							
2002	0.1	1.4	2.3	-4.8	-0.4	-0.6	0.7
Q4	1.7	-1.1	-0.1	5.7	-0.7	0.1	1.6
2003							
Q1	1.9	0.9	1.3	2.4	0.6	2.0	-0.1
Q2	3.5	0.5	0.2	10.2	-0.5	2.4	1.1
Q3	2.2	0.2	..	5.5	..	1.6	0.7
Euro Area							
2002	0.9	0.5	2.8	-2.9	..	0.2	0.6
Q4	0.1	1.3	0.6	1.2	0.1	1.2	-1.0
2003							
Q1	..	2.3	1.5	-4.5	1.2	1.9	-1.8
Q2	-0.2	0.8	2.7	-0.8	0.1	1.0	-1.2
Q3	1.5	….	….	….	….	….	….
United Kingdom							
2002	1.7	3.6	2.4	1.8	-0.2	2.9	-1.4
Q4	2.1	5.2	2.0	3.4	1.5	5.8	-3.9
2003							
Q1	0.7	-0.6	10.7	-2.8	-1.3	-0.2	1.0
Q2	2.4	2.7	2.1	5.1	-1.1	2.0	0.4
Q3	2.3	….	….	….	….	….	….
Canada							
2002	3.3	3.4	3.0	1.3	0.8	3.7	-0.3
Q4	1.6	4.4	2.4	0.1	1.4	4.6	-3.2
2003							
Q1	2.6	4.4	2.4	6.5	3.2	7.9	-4.1
Q2	-0.3	2.7	3.6	2.7	-2.6	0.1	-1.1

Sources: National statistics and Eurostat.

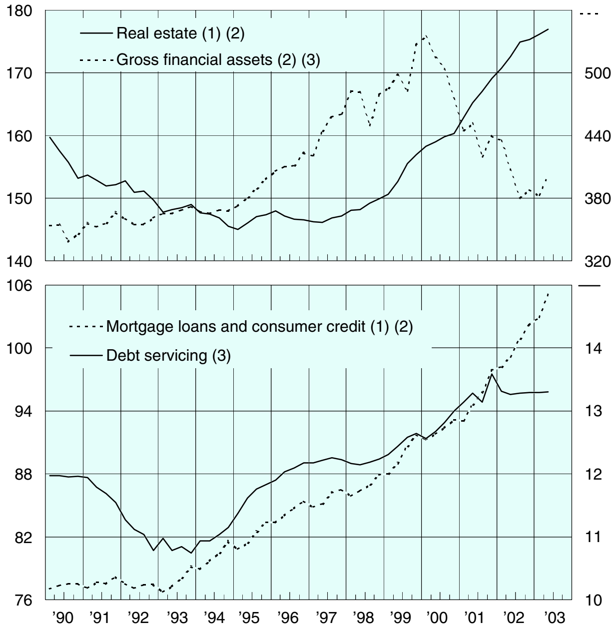
(1) Table a1 in the Appendix gives these countries' share of world GDP in 2002. Interim GDP figures are provisional and not necessarily consistent with the performance of the components. – (2) Comprises consumption of resident households and non-profit institutions serving households. – (3) For the United States, private investment; public investment is included under "government consumption". – (4) Contribution to GDP growth with respect to the previous period, at an annual rate, in percentage points. For the United States, calculated following the methodology of the Bureau of Economic Analysis. For the United Kingdom and Canada, our estimates. – (5) For the euro area and the United Kingdom also includes changes in valuables. – (6) Goods and services.

19 percentage points to 401.2 per cent; the value of real estate holdings also rose, although its pace of increase slowed (Figure 3). Households' net wealth, which includes consumer durables, rose by some 16 percentage points to 517.8 per cent of disposable income.

Figure 3

US households' assets and liabilities

(end-of-period quarterly data; as a percentage of disposable income)



Source: Federal Reserve.

(1) Left-hand scale. – (2) For disposable income, the moving average for the 4 quarters ending in the one indicated. – (3) Right-hand scale.

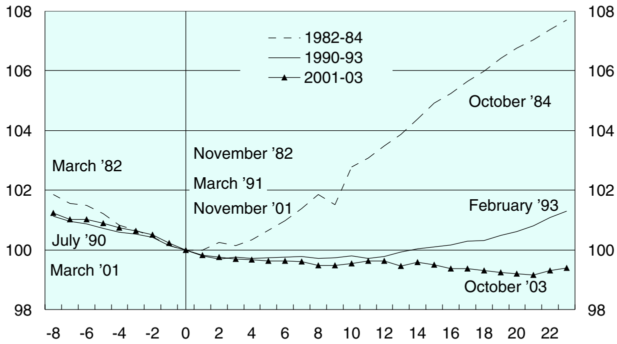
Payroll employment in the non-farm sector fell by 510,000 jobs between January and July, turned upwards in August, then increased by around 125,000 in September and again in October. After the first twenty-three months of growth, payroll employment in the non-farm sector had increased by 1.3 per cent in the 1990s expansion (from March 1991 to March 2001) and by 7.7 per cent in that of the 1980s (from November 1982 to July 1990); in the present cycle it has fallen by 0.6 per cent (Figure 4).

The curve of expected short-term interest rates implicit in futures contracts, which progressively shifted downwards and flattened between March and mid-June, moved sharply upwards and gained a positive slope in the following months. On 10 November investors expected an initial rise in official rates by the second quarter of 2004 (Figure 5).

Figure 4

United States: payroll employment in the non-farm sector before and after the trough in the last three cycles (1)

(index, trough of each cycle=100)



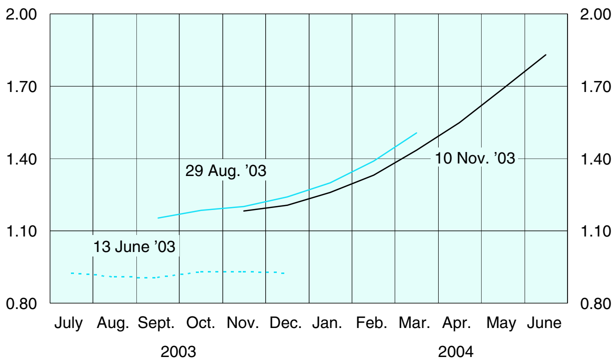
Source: Bureau of Labor Statistics.

(1) The horizontal axis shows the number of months before and after the trough.

Figure 5

United States: forward interest rates implicit in futures on 3-month deposits (1)

(percentages)



Source: Thomson Financial Datastream.

(1) Each curve relates to the contract date indicated. The horizontal axis shows the settlement dates for the futures contracts to which the yields refer.

Fiscal policy is expected to remain highly expansionary in 2004. According to recent estimates by the Congressional Budget Office the federal budget deficit, which rose to $374 billion, equal to 3.5 per cent of GDP, in the 2003 fiscal year ending in September, will reach $480 billion in the current fiscal year (4.3 per cent of GDP). The expansionary measures approved by Congress in May – which bring forward to 2003 tax cuts that were to be introduced gradually between 2004 and 2008 and reduce taxation on dividends and capital gains – cost $62 billion in the 2003 fiscal year and will cost $148 billion, equal to about 1.3 per cent of GDP, in 2004.

General government net borrowing amounted to 4.3 per cent of GDP in the first three quarters of the 2003 fiscal year, compared with a surplus of 1.3 per cent in 2000. The rise in transfers to households contributed to the deterioration in local government finances, which registered a deficit of 1.1 per cent of GDP, compared with 0.5 per cent in the 2000 fiscal year.

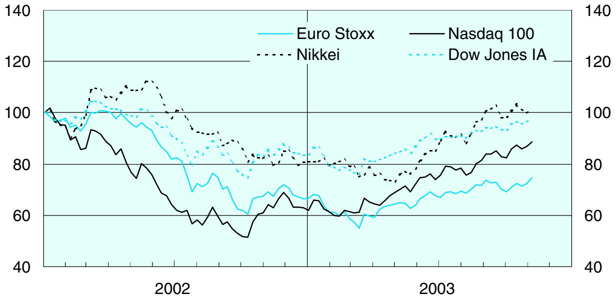
The worsening of the public sector's financial position over the last three years was only partly offset by the improvement in that of the private sector, which returned to balance in 2002. The balance-of-payments deficit on current account correspondingly widened to over 5 per cent of GDP in the first half of 2003, compared with 4.6 per cent in 2002.

Financial markets in the United States

The decline in share prices that began in the spring of 2002 came to an end on the eve of the conflict in Iraq. Prices then rose, with brief interruptions, until the start of November. With liquidity in ample supply, the equity market was buoyed by the easing of international tensions and better-than-expected corporate profits. Between mid-March and the first third of November the Dow Jones Industrial Average rose by 30 per cent and the Nasdaq 100 by 48 per cent (Figure 6).

Figure 6

Stock market indices in the United States, the euro area and Japan
(weekly averages; 1st week of January 2002=100)



Source: Thomson Financial Datastream.

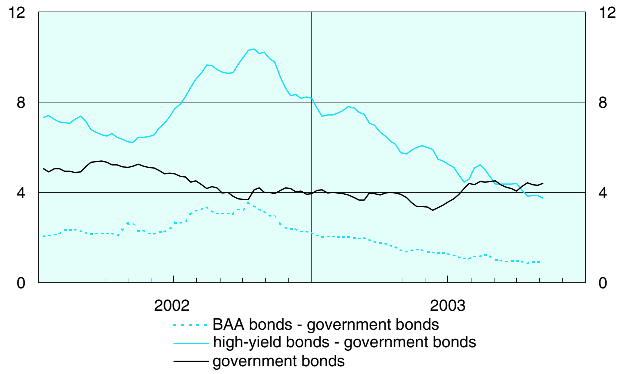
At the end of the first ten days of November the price/earnings ratio of the Thomson Financial Datastream equity index, which combines about 1,000 traditional and high-tech stocks, stood at 22.2, compared with an average of about 16 between 1973 and 2002. As is normal at the start of a recovery, this reflected expectations of rapid profit growth.

The volatility of share indices implicit in the prices of derivatives diminished sharply: after reaching very high levels in the immediate run-up to the war in Iraq (33 per cent for the Dow Jones and 42 per cent for the Nasdaq 100), volatility gradually declined; by 10 November it had fallen to 16 and 29 per cent respectively for the two indices.

Yields on ten-year Treasury bonds were stable at around 4 per cent in the first four months of 2003 but then fell to 3.1 per cent between early May and mid-June, the lowest level in 40 years (Figure 7). The perception at the start of May of a risk of deflation or a further decline in the already low rate of inflation contributed to the demand for government securities. Thanks to plentiful liquidity and expectations of its further increase, the rise in bond prices was accompanied by a rise in share prices as well.

Figure 7

Bond yields and risk premiums in the United States (1)
(weekly averages; percentages and percentage points)



Source: Thomson Financial Datastream.
(1) Risk premiums are calculated as yield differentials between corporate bonds and 10-year government bonds.

At the end of June the Federal Reserve lowered its target for the federal funds rate by 0.25 points to 1 per cent; the cut was less than expected. The risk of deflation in the US economy subsided. The rapid improvement in both the current economic situation and the outlook contributed to a rise in long-term rates, which then spread to the other main regions. Between mid-June and the end of July the yield on ten-year Treasury bonds rose unusually rapidly from 3.1 to 4.5 per cent, and then fluctuated around a slightly lower level; on 10 November the yield was 4.5 per cent.

Technical factors accentuated the fall and subsequent rise in US bond yields. In the wake of swift growth of mortgage loans for home purchases in recent years, a mortgage-backed securities market has developed in the United States and is now considerably larger than that for Treasury securities. Since the buyers of mortgage-backed securities, mainly the federal mortgage guarantee agencies (Fannie Mae and Freddie Mac) and commercial banks, are exposed to early repayment risk, the duration of mortgage-backed securities, unlike traditional bonds, is positively correlated with market interest rates: in order to maintain the duration of assets constant, investors in such instruments need to buy and sell large volumes of fixed-rate securities, generally Treasury securities and interest rate swaps, which amplifies movements in the latter markets. In addition, the steepening of the yield curve that has occurred since the Federal Reserve lowered official rates to such low levels, together with expectations of stable or falling bond yields, has made it attractive for large investors, including hedge funds, to borrow at short term and invest at long term (so-called carry trade): the sometimes rapid opening and closure of these positions magnifies variations in long-term rates.

Although these technical factors do not determine the direction of long-term yields but only accentuate changes, the presence of substantial carry-trade positions and the dominance of the mortgage-backed securities market with respect to other fixed-income instruments are a source of concern for monetary authorities, especially in the event of a change in the stance of monetary policy.

Mortgage interest rates tracked developments in bond yields. After recording a low of 5.3 per cent in June, they rose above 6 per cent again in August and then fluctuated around that level. Housing prices, which rose by 7.3 per cent in 2002, moderated somewhat in the second quarter of this year to 5.6 per cent growth over the year-earlier period. The rise in property prices and historically low interest rates in the first half allowed households to continue to reduce interest expense and increase borrowing by renegotiating mortgages. In the first half of the year, new mortgages amounted to $1,743 billion, equal to 70 per cent of total mortgage lending in 2002. Between mid-2002 and mid-2003 households' gross debt rose from 99.2 to 105.1 per cent of disposable income, while debt servicing charges held steady at 13.3 per cent (Figure 3). The rise in rates over the summer will slow the growth in new mortgage lending and refinancing in the coming months.

The improvement in firms' profitability hastened the decline in risk premiums on corporate bonds that began in the autumn of 2002. Since the beginning of March the yield spread between private BAA-rated bonds and Treasury bonds has narrowed by 1.1 percentage points and that for high-yield bonds issued by riskier companies by 3.9 points, bringing the total decline since October 2002 to 2.7 and 6.6 points respectively (Figure 7).

The depreciation of the dollar against the euro, which began in February 2002 and continued through the early months of this year, came to a halt at the end of May. Reflecting the quickening of economic activity in the United States relative to that in the euro area, the dollar strengthened from $1.19 per euro to $1.08 at the start of September. The release of worse-than-expected macroeconomic data for the US economy in the first week of that month triggered a new slide, which lasted through October; on 10 November the euro stood at $1.15 (Figure 1).

Between the end of May and mid-September the exchange rate of the dollar against the yen fluctuated between ¥116 and ¥120, thanks in part to substantial purchases of dollars by Japanese monetary authorities to counter the appreciation of the yen. The dollar sagged from the middle of September onward, falling to ¥108 in reaction to the suspension of intervention by the Japanese authorities and the 20 September communiqué of the finance ministers and central bank governors of the G7 countries at their meeting in Dubai. Over the same period the dollar came under downward pressure even vis-à-vis the currencies of China and Hong Kong, which are pegged to the US currency. On 10 November the 1-year forward rate of the renminbi reflected expectations of a revaluation of 4 per cent; in Hong Kong the strains were signaled by the sharp fall in overnight rates, which dropped from 1 to 0.1 per cent. Between mid-September and the first ten days of October, the dollar weakened slightly against the currencies of South Korea, Indonesia and Thailand; it subsequently recouped the losses entirely.

According to the Federal Reserve's exchange rate indicator, between the start of September and 10 November the dollar depreciated by 3.3 per cent in nominal effective terms. The depreciation since February 2002 amounted to 9.9 per cent: the sharp loss of value against the euro (24.2 per cent), the yen (18.6 per cent) and the pound (14.9 per cent) was offset by broad stability against the currencies of the emerging Asian economies and an appreciation against those of Latin America. The real effective depreciation of the dollar between February 2002 and last October was also 9.9 per cent (Figure 1).

The economic and financial situation in the emerging economies and the countries acceding to the European Union

After slowing in the second quarter, output growth in China resumed its very rapid pace (9.1 per cent on the corresponding period of 2002; Table 2). In the first nine months of the year investment rose by an average of more than 30 per cent in nominal terms with respect to the year-earlier period. The substantial trade surplus, which was equal to 3.6 per cent of GDP in 2002, decreased significantly as imports surged (Table 3). Since the start of the year the renminbi has depreciated by 5.2 per cent in real effective terms (Figure 8). The rapid rise in foreign currency reserves under way since 1994 continues unabated. This has exerted an expansionary impact on liquidity, which has been only partly sterilized by the central bank. In the first half of 2003 the money supply and bank credit increased by 20 per cent

Table 2

Economic indicators for selected emerging countries

(at constant prices; unless otherwise indicated, percentage changes on year-earlier period)

	% of world GDP in 2002		GDP					Domestic demand (3)				Net exports (4)			
	(1)	(2)	2002	2002 Q4	2003 Q1	2003 Q2	2003 Q3	2002	2002 Q4	2003 Q1	2003 Q2	2002	2002 Q4	2003 Q1	2003 Q2
Latin America															
Argentina	0.7	0.3	-10.9	-3.4	5.4	7.6	….	-17.1	-7.3	6.2	9.2	6.0	3.6	-0.3	-0.8
Brazil	2.6	1.4	1.5	3.4	2.0	-1.4	….	-0.3	….	….	….	1.8	….	….	….
Mexico	1.9	2.0	0.9	1.9	2.3	0.2	….	1.0	1.6	1.2	-0.6	-0.1	0.2	1.0	0.7
Asia															
China	12.7	3.9	8.0	8.1	9.9	6.7	9.1	….	….	….	….	….	….	….	….
India (5)	4.8	1.5	4.7	2.3	4.9	5.7	….	….	….	….	….	….	….	….	….
Indonesia	1.6	0.5	3.8	3.4	3.4	3.8	….	2.0	6.9	5.6	3.4	1.8	-3.1	-1.8	0.5
Malaysia	0.4	0.3	4.1	5.4	4.6	4.4	….	7.0	6.1	4.6	1.5	-2.1	-0.2	0.4	3.1
Philippines	0.7	0.2	4.4	5.8	4.5	3.2	….	4.9	9.8	13.7	5.4	-0.9	-4.7	-9.9	-2.9
South Korea	1.8	1.5	6.3	6.8	3.7	1.9	….	5.2	2.2	1.4	-1.1	2.0	4.9	2.5	2.8
Taiwan	1.0	0.9	3.6	4.5	3.5	-0.1	….	1.0	2.8	3.0	-2.8	2.6	2.0	0.9	2.5
Thailand	1.0	0.4	5.3	6.2	6.7	5.8	….	4.5	5.7	5.9	5.6	1.4	1.6	1.7	0.9
Europe															
Poland	0.8	0.6	1.4	2.2	2.2	3.8	….	1.0	….	….	….	0.4	….	….	….
Russia	2.7	1.1	4.3	5.2	6.8	7.2	….	6.0	7.2	7.6	10.1	-0.7	-0.9	0.7	-1.3
Turkey	0.9	0.6	7.8	11.4	8.1	3.9	….	9.2	14.7	11.6	6.7	-0.9	-2.2	-3.4	-2.8

Sources: National statistics, IMF and OECD.

(1) On the basis of purchasing power parities. – (2) On the basis of market exchange rates. – (3) Includes change in stocks and statistical discrepancies. – (4) Contribution to GDP growth in relation to the same period of the previous year in percentage points. Includes goods and services. – (5) GDP at factor cost.

Table 3

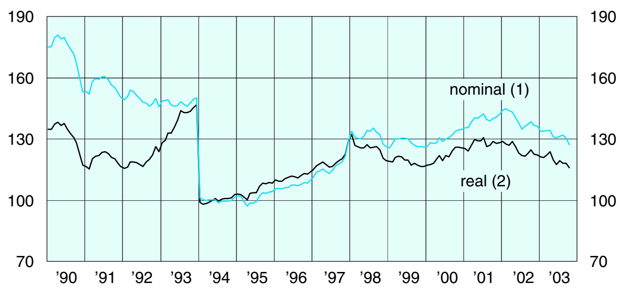
China's balance of payments
(net flows in millions of dollars)

	1990	1994	1997	1999	2000	2001	2002
Current account	**11,997**	**6,908**	**36,963**	**21,115**	**20,518**	**17,401**	**35,422**
Goods	9,165	7,290	46,222	35,982	34,474	34,017	44,167
Capital account	**....**	**....**	**-21**	**-26**	**-35**	**-54**	**-50**
Financial account	**3,255**	**32,645**	**21,037**	**5,204**	**1,958**	**34,832**	**32,341**
Direct investment	2,657	31,787	41,674	36,978	37,483	37,357	46,790
Portfolio investment	-241	3,543	6,943	-11,234	-3,990	-19,405	-10,343
Other investment	839	-2,685	-27,580	-20,540	-31,535	16,880	-4,106
Errors and omissions	**-3,205**	**-9,100**	**-22,122**	**-17,641**	**-11,748**	**-4,732**	**7,504**
Reserve assets (1)	**-12,047**	**-30,453**	**-35,857**	**-8,652**	**-10,693**	**-47,447**	**-75,217**
Memorandum items:							
Current account balance as a percentage of GDP	3.1	1.3	4.1	2.1	1.9	1.5	2.9
Trade balance as a percentage of GDP	2.4	1.3	5.1	3.6	3.2	2.9	3.6

Source: IMF.
(1) A minus sign indicates an increase.

Figure 8

China: nominal and real effective exchange rates
(monthly averages; indices, 1994 average=100)



Source: J.P. Morgan Chase.

(1) Calculated on the basis of trade with 16 countries; an increase indicates an appreciation. – (2) Calculated on the basis of producer prices and trade with 47 countries; an increase indicates a decrease in competitiveness.

compared with a year earlier. In a system dominated by public-sector banks, the abundance of liquidity boosted lending to firms with low earnings prospects or high risk. According to official estimates, at the end of 2002 bad debts in the financial system amounted to 45 per cent of GDP; those in the banking system came to 32 per cent of GDP, or about one-fourth of all loans.

In South Korea, GDP growth slowed in the second quarter to 1.9 per cent with respect to the year-earlier period as a result of a sharp contraction in consumption and a weakening in exports, especially to the United States. In the region's developing countries economic activity remained strong overall, thanks in part to the strength of domestic demand.

An important factor in sustaining the growth of the emerging Asian economies was the robust performance of trade within the region, which expanded by 20 per cent in dollar terms in the first five months of the year by comparison with the year-earlier period (Table 4). China's share of regional trade has grown steadily over the last decade: its products account for nearly 15 per cent of the imports of the area's other emerging countries and it takes in 13.8 per cent of their exports (5.9 per cent in 1990). The geographical distribution of China's trade flows has gradually shifted. Exports, half of which went to the emerging economies of the

Table 4

Foreign trade of the emerging Asian countries, by counterparty (1)
(*current dollars*)

	Exports						Imports					
	China			Other countries			China			Other countries		
	1990	1995	2002	1990	1995	2002	1990	1995	2002	1990	1995	2002
	Percentage share of world flows											
	1.9	2.9	5.1	11.5	15.7	14.5	1.5	2.6	4.4	11.8	16.8	14.1
	Percentage distribution of flows by counterparty											
United States ...	8.3	16.6	21.5	24.2	20.0	19.8	12.5	12.2	9.2	15.5	14.2	11.6
EU	9.6	12.9	14.8	17.6	14.8	14.8	17.1	16.1	13.1	15.1	14.1	11.5
Japan	14.3	19.1	14.9	14.3	11.5	9.6	14.5	21.9	18.1	21.8	21.3	15.7
Asia (1)	53.4	40.1	34.0	30.0	40.6	42.8	37.2	33.7	37.9	29.7	35.3	44.2
of which:												
China	–	–	–	*5.9*	*9.7*	*13.8*	–	–	–	*8.7*	*10.9*	*14.6*
	2001	2002	2003 (2)	2001	2002	2003 (2)	2001	2002	2003 (2)	2001	2002	2003 (2)
	Percentage changes in flows on previous year											
Total	7.0	22.1	34.9	-6.4	4.8	16.1	8.2	21.3	26.2	-9.4	7.7	13.7
of which:												
Japan	*8.2*	*7.6*	*20.7*	*-5.7*	*-3.8*	*15.7*	*3.1*	*24.9*	*22.8*	*-19.9*	*8.4*	*14.6*
Asia (1)	*5.8*	*26.2*	*20.5*	*-8.5*	*4.1*	*20.1*	*4.2*	*30.0*	*29.1*	*-6.7*	*12.5*	*17.0*

Source: IMF, *Direction of Trade Statistics.*
(1) Includes the countries of South-East Asia; excludes Japan. – (2) First five months of the year.

region at the start of the last decade, are increasingly directed to the two largest industrial markets, the United States and the European Union, which in 2002 took respectively 21.5 and 14.8 per cent of Chinese exports. By contrast, since the mid-1990s a growing share of China's imports has originated in Asia's other emerging economies (rising from 33.7 per cent in 1995 to 37.9 per cent in 2002). Trade with Japan has decreased as a proportion of the total: between 1995 and 2002 the shares of China's exports to and imports from Japan have decreased by about 4 percentage points each, to 14.9 and 18.1 per cent respectively. The share of imports from the major industrial economies has also contracted markedly.

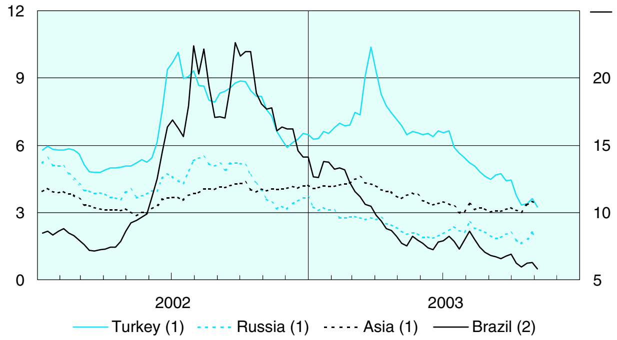
Since the spring of this year, the terms of access to international credit have eased for all of the region's emerging countries. After widening between August 2002 and March 2003 owing to international political tensions, the yield spread between dollar-denominated bonds issued by Asian countries and the corresponding US Treasury bonds has narrowed, returning to its previous level; the average for the region has fallen by 1.1 points from its peak last March to 3.3 points (Figure 9).

In Argentina, the economy staged a recovery in the first half of the year, although unresolved structural problems make it fragile. In the second quarter GDP grew by 7.6 per cent with respect to the corresponding period of 2002, reflecting a further rise in domestic demand and exports (Table 2). Consumer price inflation continued to subside gradually in connection with the appreciation of the peso from the low recorded in June 2002; in October, the twelve-month inflation rate was 1.9 per cent. In the first half of the year the public sector budget showed a primary surplus of 1.4 per cent of GDP thanks to the strong performance of tax revenues. In September the government reached an agreement with the IMF on a three-year financial assistance programme totaling $12.5 billion, which prevented default on the country's debt with international organizations. It subsequently submitted a proposal for the restructuring of part ($94 billion) of the public debt on which Argentina had declared a moratorium in December 2001.

Figure 9

Yield differentials between long-term dollar-denominated bonds issued by selected emerging countries and 10-year US Treasury bonds

(weekly averages; percentage points)



Sources: J.P. Morgan Chase for Brazil; Thomson Financial Datastream for the other countries.

(1) Left-hand scale. – (2) Right-hand scale.

In Brazil, after turning upward in 2002 under the impetus of foreign demand, GDP decreased by 1.4 per cent in the second quarter of 2003 from the year-earlier period. Domestic demand was adversely affected by the restrictive stance of fiscal and monetary policy. In the first nine months of the year, the primary surplus increased from its level a year earlier; at 5.1 per cent of GDP, it was larger than the objective agreed with the IMF.

In Mexico, where domestic demand remains weak, output was just 0.2 per cent greater in the second quarter of 2003 than a year earlier. The economy should benefit from the recovery of demand in the United States and the easing of monetary conditions as inflationary pressures diminish.

In the main Latin American countries, the behaviour of exchange rates against the dollar reflected economic developments and the stance of monetary policy. In Argentina, the peso has held steady since March; it has appreciated by nearly 40 per cent from its historical low in June 2002 following the abandonment of the currency board. In Brazil, the real has stabilized since the second half of April. Since October 2002, the decline in the uncertainty engendered by the presidential elections in that month and the subsequent monetary tightening have fostered an appreciation of 40 per cent in the currency. After a period of appreciation the Mexican peso began to depreciate again, slipping by 8 per cent between mid-May and 10 November; since April 2002, when it first began to weaken, the currency has depreciated by 18 per cent.

Yield differentials between long-term dollar-denominated bonds and US Treasury securities decreased in tandem in Brazil and Mexico. Compared with average March values, spreads narrowed by 5.2 and 1.1 percentage points to 5.7 and 1.9 points respectively on 10 November; the decline from the peaks recorded in September 2002 was 18.6 and 2.5 points respectively (Figure 9).

In the countries that will join the European Union in May 2004 economic performance remained positive in the first half of 2003 despite the slackening of external demand.

In Turkey, economic activity slowed sharply in the second quarter, partly owing to political tensions in the region, registering growth of 3.9 per cent with respect to the same period of 2002. The dissipation of domestic political strains and those associated with the war in Iraq, together with financial assistance from the IMF in August and from the United States in September, helped improve economic and financial conditions. The yield spread with respect to the corresponding US Treasury securities narrowed by 7.3 points to 3.8 points (Figure 9). The lira has recovered, appreciating by 18 per cent against the dollar since March. The economic situation improved in the summer, marked by an acceleration in industrial production.

In Russia, output growth, which was more than 4 per cent in 2002, accelerated to 7 per cent in the first half of the year with respect to the year-earlier period, boosted by the growth in the energy sector. Domestic demand continued to expand rapidly. Financial markets benefited from the improvement in economic conditions. Between January and July 2003 the rouble appreciated by 5 per cent against the dollar and then stabilized. In October the promotion of Russian government securities to investment grade by a leading international rating agency caused the spread vis-à-vis the corresponding US Treasury securities to narrow further; since March it has decreased by 1.3 points to 2.6 points, one of the lowest levels in the emerging regions (Figure 9).

ECONOMIC DEVELOPMENTS IN THE EURO AREA AND ITALY

Production, demand and the balance of payments

In the first half of 2003, while growth accelerated in the United States and Japan, in the euro area the cyclical softening that began in the second half of last year grew more pronounced. GDP stalled in the first quarter and contracted slightly in the second (Table 6).

Economic activity was affected chiefly by the fall in exports. With imports broadly stable, net exports cut GDP growth by 1.5 percentage points in the first half on an annual basis (Figure 11).

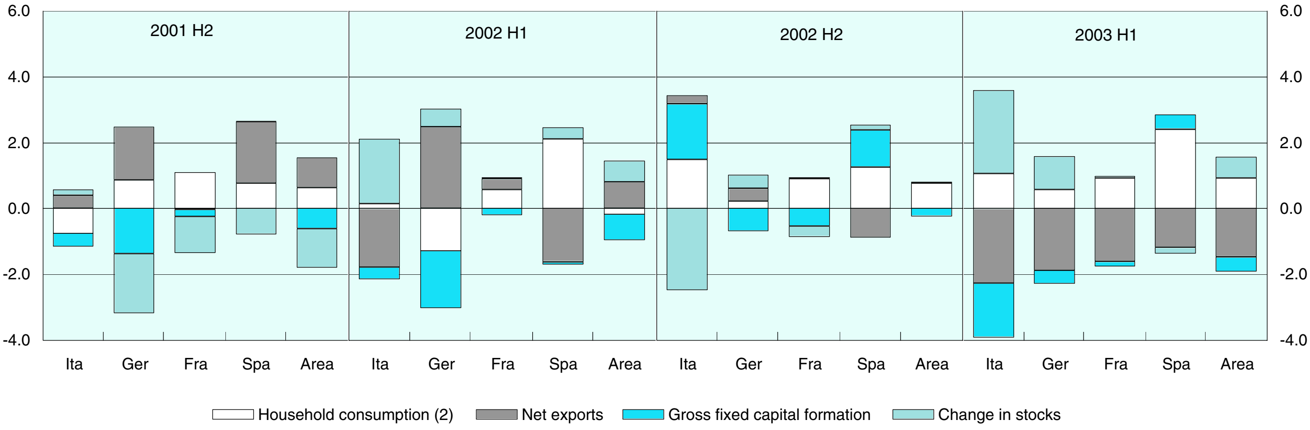
Household consumption and stockbuilding made a positive contribution to output growth (0.9 and 0.6 points respectively), while capital formation trimmed 0.5 points, contracting by 2.2 per cent in reflection of considerable spare capacity and the continued pessimism of firms.

Economic activity in Italy has been sluggish since mid-2001. In the first six months of this year output fell slightly after having registered a temporary rise of 1.1 per cent in the previous half-year that was largely related to the imminent expiry of tax incentives for investment and motor vehicle purchases (Table 7). Capital formation and exports both contracted much more sharply than in the rest of the euro area (Table 6).

Value added in services continued to increase, albeit at a rate (0.9 per cent) only half that of the previous half-year, and in construction (3.2 per cent). The contraction in value added in industry over the last two years continued. Industrial activity decreased in all areas of the country.

Figure 11

Contributions of the main components of demand to the growth of GDP in the euro area and the major euro-area countries (1)
(seasonally adjusted at constant prices; percentage points; with respect to previous period and annualized)



Source: Based on national statistics.
(1) Excludes consumption of general government. – (2) Consumption of resident households and non-profit institutions serving households.

Table 6

GDP, imports and the main components of demand in the major euro-area countries
(at seasonally adjusted constant prices; percentage changes)

	On corresponding period							On previous period, annualized					
	2002			2003				2002		2003			
	Q3	Q4	2002	Q1	Q2	Q3	H1	Q3	Q4	Q1	Q2	Q3	H1
							GDP						
Germany (1)	0.4	0.5	0.2	0.1	-0.3	-0.2	-0.1	0.6	-0.2	-1.0	-0.6	0.9	-0.7
France (1)	1.3	1.3	1.2	0.7	-0.3	-0.1	0.2	0.8	-1.2	0.6	-1.3	1.4	-0.3
Italy (1)	0.4	0.9	0.4	0.7	0.2	0.5	0.5	0.8	1.5	-0.7	-0.6	2.0	-0.2
Spain	1.8	2.1	2.0	2.2	2.3	….	2.2	2.7	1.7	2.1	2.7	….	2.1
Euro area (1)	1.0	1.1	0.9	0.7	0.2	0.3	0.5	0.9	0.1	..	-0.2	1.5	..
							Imports						
Germany	..	2.1	-1.7	6.8	2.3	….	4.5	4.1	3.7	6.0	-4.4	….	2.7
France	2.1	3.1	0.6	1.6	0.7	….	1.1	3.4	-2.0	0.6	0.9	….	..
Italy	5.5	8.2	1.5	3.1	2.4	….	2.7	9.2	9.0	-17.3	11.7	….	-4.5
Spain	3.5	10.5	1.8	8.1	10.1	….	9.1	16.9	18.2	-5.2	12.2	….	4.5
Euro area	1.9	3.7	0.1	4.0	1.6	….	2.8	5.4	2.8	-1.9	0.3	….	-0.2
							Exports						
Germany	4.6	5.4	3.4	4.0	-0.4	….	1.8	8.6	0.4	-1.2	-8.7	….	-2.7
France	2.5	3.7	1.5	-0.2	-3.2	….	-1.7	1.0	-2.7	-8.3	-2.4	….	-5.5
Italy	3.6	4.0	-1.0	1.3	-2.9	….	-0.9	14.1	-3.0	-21.0	1.8	….	-11.4
Spain	1.0	5.4	..	5.0	7.7	….	6.3	18.7	9.9	-8.3	12.4	….	1.0
Euro area	3.3	4.2	1.7	2.3	-0.9	….	0.7	6.0	-0.1	-6.3	-2.8	….	-3.9
							Household consumption (2)						
Germany	-1.2	-0.6	-1.0	0.8	0.6	….	0.7	0.5	-0.1	2.1	0.1	….	1.0
France	1.2	1.5	1.2	1.9	1.5	….	1.7	1.7	1.3	2.7	0.1	….	1.7
Italy	0.8	2.0	0.4	2.3	2.0	….	2.1	1.7	3.9	0.8	1.7	….	1.8
Spain	2.7	3.0	2.6	3.0	3.1	….	3.1	1.0	2.6	4.8	4.1	….	4.1
Euro area	0.3	0.8	0.5	1.6	1.4	….	1.5	1.2	1.3	2.3	0.8	….	1.7
							Gross fixed capital formation						
Germany	-6.4	-5.1	-6.7	-4.4	-1.1	….	-2.8	-0.8	0.6	-4.8	0.7	….	-2.1
France	-1.5	-2.1	-1.6	-1.9	-1.5	….	-1.7	-2.6	-4.1	0.5	0.2	….	-0.8
Italy	1.0	5.5	0.5	0.9	-0.8	….	..	8.0	17.2	-19.0	-5.5	….	-7.7
Spain	1.5	2.9	1.0	3.1	3.4	….	3.2	6.1	4.4	-0.2	3.4	….	1.8
Euro area	-3.0	-1.9	-2.9	-2.3	-1.0	….	-1.7	..	1.2	-4.5	-0.8	….	-2.2
							National demand						
Germany	-1.3	-0.8	-1.6	0.7	0.7	….	0.7	-1.2	0.9	1.4	1.7	….	1.4
France	1.2	1.1	1.0	1.2	0.8	….	1.0	1.5	-0.7	3.1	-0.4	….	1.2
Italy	0.9	2.0	1.1	1.2	1.9	….	1.6	-0.7	5.2	0.9	2.4	….	2.3
Spain	2.6	3.7	2.6	3.2	3.2	….	3.2	2.6	4.4	2.8	3.0	….	3.2
Euro area	0.4	0.9	0.2	1.3	1.1	….	1.2	0.6	1.2	1.9	1.0	….	1.5

Source: Based on national statistics.
(1) Interim GDP figures are provisional and not necessarily consistent with the performance of the components. – (2) Consumption of resident households and non-profit institutions serving households.

Production and demand in the euro area

The three largest euro-area economies all saw economic activity diminish in the first six months of the year, although the timing of the downturn differed.

In Germany GDP decreased by 0.7 per cent on an annual basis, the largest contraction in a decade (Table 6). Contributory factors were falls in exports and investment in construction, which were only partially offset by the recovery in other fixed capital formation and the slight pickup in household consumption.

Economic activity also slowed in France, where GDP fell by 0.3 per cent, primarily due to the pronounced fall in exports. Growth in the first quarter (0.6 per cent) was followed by a sharp contraction in the second (1.3 per cent).

By contrast, output continued to expand in Spain, rising by 2.1 per cent, chiefly under the impulse of private consumption.

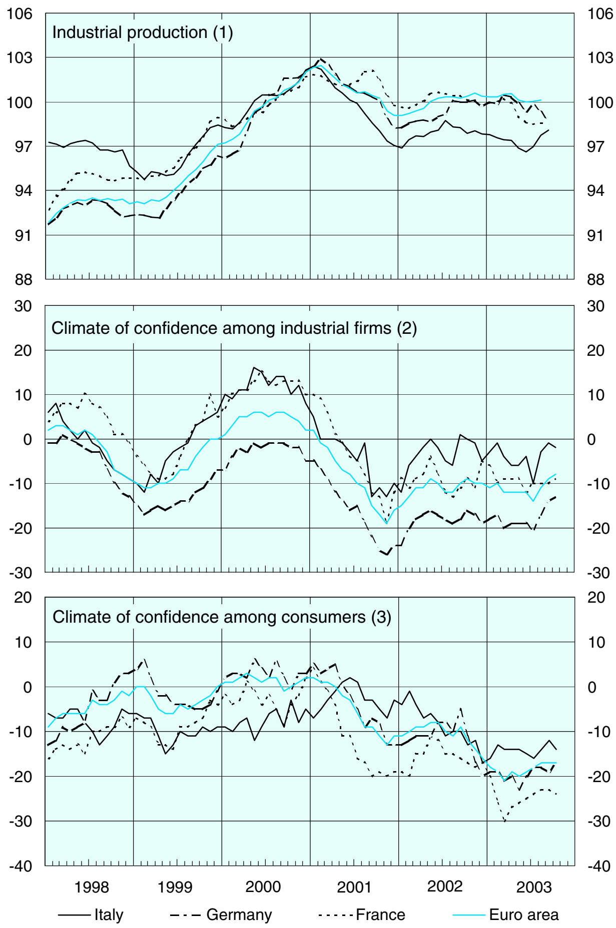
Household consumption. – Household consumption in the euro area increased by 1.7 per cent at an annual rate, compared with 1.4 per cent in the previous six months. However, growth slowed markedly during the period, from 2.3 per cent in the first quarter to 0.8 per cent in the second.

In Germany, private consumption increased by 1 per cent in the first half thanks to a temporary upturn in the first quarter. The modest recovery was due to a rise of 2.2 per cent in gross disposable income on the corresponding period of 2002, largely thanks to increased social benefits. Household confidence remained low in the first half of 2003, mainly owing to the deterioration in labour market conditions. Since June, surveys have revealed a gradual improvement in assessments, although confidence remains at historically low levels (Figure 12).

In France, household consumption rose by 1.7 per cent on an annualized basis in the first six months, while gross disposable income expanded more slowly (0.7 per cent with respect to the year-earlier period). As in Germany, uncertainty about the employment outlook affected household confidence, which fell sharply in the first quarter before improving moderately in subsequent months.

Figure 12

Industrial production and the climate of confidence among industrial firms and consumers in the euro area and selected euro-area countries
(monthly data)



Sources: Based on national statistics and European Commission data.

(1) Index, 2000=100. Moving averages for the three months ending in the reference month. Data adjusted for the different number of working days in the month and seasonally adjusted. – (2) Climate of confidence calculated by the European Commission as the average of the seasonally adjusted percentage balances of the responses to questions regarding the level of orders, production expectations and stocks of finished products. – (3) Climate of confidence calculated by the European Commission as the average of the seasonally adjusted weighted percentage balances of the responses to five questions on consumers' opinions and expectations regarding the economic situation, both general and personal, and intentions regarding the purchase of durable goods.

In Spain, household spending rose by 4.1 per cent, nearly twice the rise in the second half of 2002, and continued to sustain GDP growth. Consumption benefited from the increased purchasing power of households produced by higher employment and the significant reduction in inflation.

Investment and stocks. – Investment in the euro area continued the downward trend under way since the end of 2000, falling by 2.2 per cent on an annualized basis in the first half of the year. Construction spending contracted by a further 1.1 per cent, while the other components turned down again (3.2 per cent) after the temporary improvement in the previous period.

In the main euro-area countries and in the area as a whole, the fall in capital formation reflected considerable spare capacity.

In Germany gross fixed capital expenditure decreased by 2.1 per cent in the first half, although this was a smaller fall than in the previous two years. The decline is attributable to investment in construction, which has been falling since the beginning of 2000. It decreased by 5 per cent despite the stimulus of reconstruction in the regions affected by flooding last year and the recent start of a renovation programme for residential buildings. Purchases of machinery, equipment and transport equipment began to rise again (1.5 per cent) after having dropped by 10.9 per cent over the previous two years.

Capital formation in France decreased by 0.8 per cent, the fourth six-month decline in a row; construction investment registered the sharpest decrease (1.7 per cent).

After increasing considerably in the second half of 2002, investment slowed in Spain as expenditure on machinery, equipment and transport equipment stagnated.

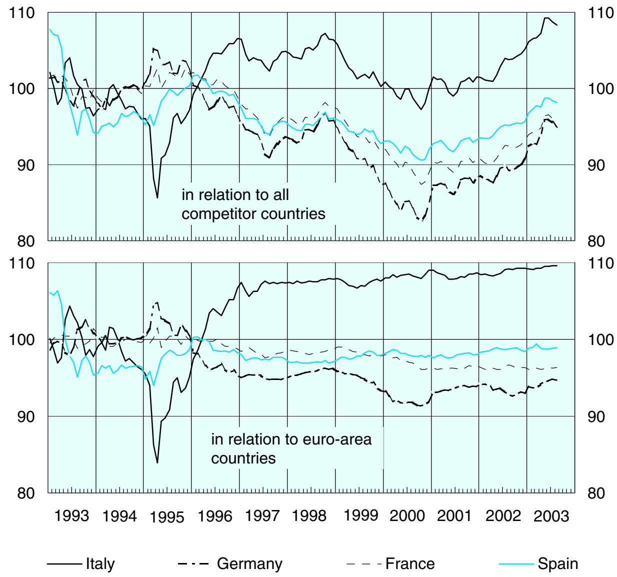
Exports and imports. – In the first half of 2003 euro-area exports declined by 3.9 per cent at an annual rate, compared with an increase of 5.5 per cent in the previous six months.

Developments in imports and exports reflected the modest growth in international trade, which expanded by an estimated 2.5 per cent in the first nine months compared with the year-earlier period. The significant appreciation of the euro since last year has also eroded the price competitiveness of all the major euro-area economies. Gauged by the producer prices of manufactures, the loss of competitiveness worsened in the first half of this year, especially in Germany (Figure 13).

Figure 13

Indicators of competitiveness in the major euro-area countries (1)

(monthly data; indices, 1993=100)



Source: Based on national statistics.

(1) Based on the producer prices of manufactures. An increase in the index indicates a loss of competitiveness.

Imports slowed sharply with respect to the previous period, going from an increase of 5.9 per cent to a decrease of 0.2 per cent as economic activity weakened.

The deterioration in foreign trade affected all the main economies. Unlike 2002, when the impulse of external demand offset the fall in domestic demand, this year the weakness of the German economy has been accentuated by the contraction in exports, which fell by 2.7 per cent in the first half. Import growth in Germany slowed to 2.7 per cent from 6.3 per cent in the previous half. Net exports cut 1.9 points from GDP growth.

France also registered a pronounced fall in exports (5.5 per cent), mainly concentrated in the first quarter, when they dropped by 8.3 per cent. With imports stationary, foreign trade reduced GDP growth by 1.6 points.

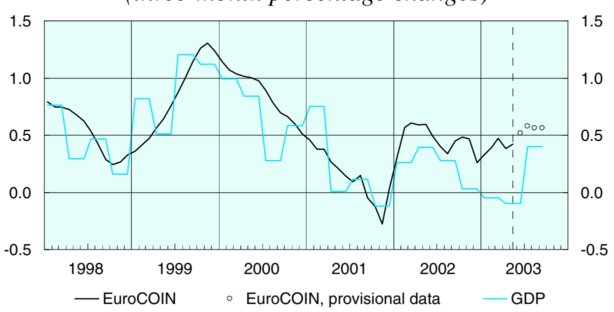
In Spain export growth slowed abruptly, to 1 per cent. Imports increased significantly (4.5 per cent), although the rise was less than that in the previous half-year, when they grew by 14 per cent. Net exports made a negative contribution of 1.2 percentage points to output growth.

Recent developments. – Preliminary official estimates show growth resuming in the third quarter in Germany, France, Italy and the euro area as a whole, with annualized rates of 0.9, 1.4, 2 and 1.5 per cent respectively (Table 6).

Cyclical indicators for the euro area have improved slightly starting in the summer. The EuroCOIN coincident indicator – which provides an estimate of monthly euro-area GDP growth excluding seasonal and erratic components – improved gradually between May and July. However, the recovery appears to have stalled in the subsequent two months (Figure 14).

Figure 14

EuroCOIN coincident indicator of the euro-area business cycle and GDP (1)
(three-month percentage changes)



(1) The method of constructing the indicator is described in the "Note metodologiche" section of the Appendix to the Bank's Annual Report for 2002 in Italian. The GDP figure for the third quarter of 2003 is provisional.

European Commission surveys show the climate of confidence of industrial firms improving for the third month in a row in October, boosted by more optimistic production expectations and, more recently, stronger demand (Figure 12).

In July and August industrial output increased by 0.7 per cent with respect to the previous two-month period. While the index was virtually unchanged in France (with growth of just 0.1 per cent), it rose by 0.6 per cent in Germany and 2 per cent in Italy, although this was followed by declines of 1.5 and 0.7 per cent respectively in September (Figure 12).

The components of demand in Italy

Household consumption. – In the first six months of 2003, private consumption in Italy increased by 1.8 per cent on an annualized basis, compared with a rise of 2.5 per cent in the previous half (Table 7). The slowdown reflected the decrease in purchases of durable goods, with transport equipment registering a steep drop of 18 per cent following the expiry of tax incentives for purchases of vehicles with a reduced environmental impact. Expenditure on services grew steadily, and that on non-durables accelerated.

Household spending was affected by the slow pace of income growth and consumer pessimism. In the first half of 2003, real disposable income rose by just over 1 per cent with respect to the year-earlier period. The main factor in the rise was the growth in the gross wage bill, which increased by about 0.5 per cent solely as a result of the expansion of employment. Preliminary estimates indicate that the decline in households' net interest income slowed, but that in income from self-employment steepened to about 2 per cent.

According to ISAE surveys, at the end of the first half of 2003 confidence had fallen to its lowest level since the recession of 1993, primarily reflecting the deterioration in assessments of the general economic situation. The index recovered slightly between July and October. Positive signals also came from new car registrations, which in the third quarter rose by 4.6 per cent on the year-earlier period, when the tax incentives for eco-friendly vehicles were still in effect.

Table 7

Italy: resources and uses of income

(seasonally adjusted at constant prices; annualized percentage changes on previous period unless otherwise indicated)

	As a percentage of GDP in 2002	2002				2003				
		Q3	Q4	H2	Year	Q1	Q2	Q3	H1	H1 (1)
Resources										
GDP (2)	-	0.8	1.5	1.1	0.4	- 0.7	- 0.6	2.0	-0.2	-
Imports	28.7	9.2	9.0	10.4	1.5	-17.3	11.7	....	- 4.5	1.3
Goods	22.2	14.1	5.0	10.7	0.8	-20.8	13.2	....	- 7.0	1.6
Services	6.5	- 6.1	23.7	9.4	4.1	- 4.8	7.1	....	4.6	- 0.3
Uses										
Gross fixed capital formation	20.8	8.0	17.2	8.4	0.5	-19.0	- 5.5	....	- 7.7	- 1.7
Construction	8.5	7.0	10.3	4.7	0.3	4.2	- 2.4	....	4.0	0.3
Machinery, equipment and sundry products	9.7	7.7	18.6	8.7	0.8	-30.6	- 2.1	....	-13.6	- 1.4
Transport equipment	2.6	12.4	35.2	20.0	0.2	-37.3	-26.5	....	-21.0	- 0.6
Consumption of resident households	59.8	1.7	3.9	2.5	0.4	0.7	1.7	....	1.8	1.1
Non-durable goods	26.3	0.4	- 0.9	0.5	- 0.3	1.9	2.4	....	1.3	0.3
Durable goods	7.0	4.0	15.2	5.4	- 2.8	- 8.2	-14.7	....	- 4.6	- 0.3
Services	27.1	0.8	4.7	2.3	0.7	0.4	3.2	....	2.2	0.6
Other domestic uses (3)	18.4	-16.7	- 3.3	-12.0	4.1	30.7	13.6	....	17.0	2.9
Total national demand	98.9	- 0.7	5.2	0.8	1.1	0.9	2.4	....	2.3	2.3
Exports	29.8	14.1	- 3.0	11.0	- 1.0	-21.0	1.8	....	-11.4	- 3.6
Goods	24.0	18.9	- 7.3	12.5	..	-26.8	1.0	....	-15.8	- 4.1
Services	5.8	- 4.2	17.4	4.8	- 4.9	6.2	4.9	....	8.5	0.5

Source: Based on Istat data.

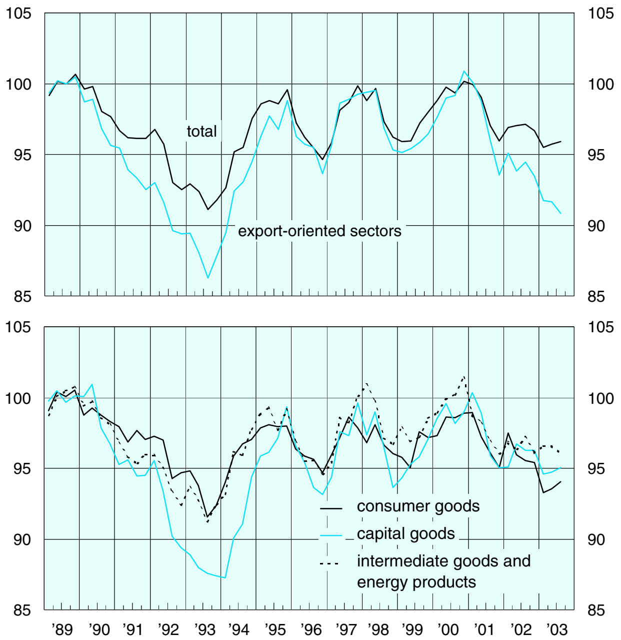
(1) Contribution to GDP growth compared with previous period; annualized in percentage points. – (2) Interim GDP figures are provisional and not necessarily consistent with the performance of the components. – (3) Comprises consumption of general government and non-profit institutions serving households, changes in stocks and valuables, and statistical discrepancies.

Investment and stocks. – In the first six months of the year investment declined by 7.7 per cent at an annual rate, reversing most of the 8.4 per cent rise registered in the second half of 2002, which had largely reflected the approaching end of capital investment incentives. Capital expenditure net of construction contracted by 15.2 per cent, compared with an increase of 11 per cent in the previous half-year; within this aggregate expenditure on transport equipment dropped by 21 per cent, compared with a rise of 20 per cent in the previous period (Table 7).

In view of the favourable terms available for financing, the long decline in capital formation reflects the persistently low level of capacity utilization, especially for exporting firms and consumer goods manufacturers (Figure 15). The deterioration in business confidence that emerges in the ISAE surveys also played a role.

Figure 15

Composite indicator of capacity utilization in Italian industry (1)
(quarterly data; index, 1989=100)



Sources: Based on Istat and ISAE data.
(1) Arithmetic mean of the Bank of Italy (Wharton) and ISAE indicators.

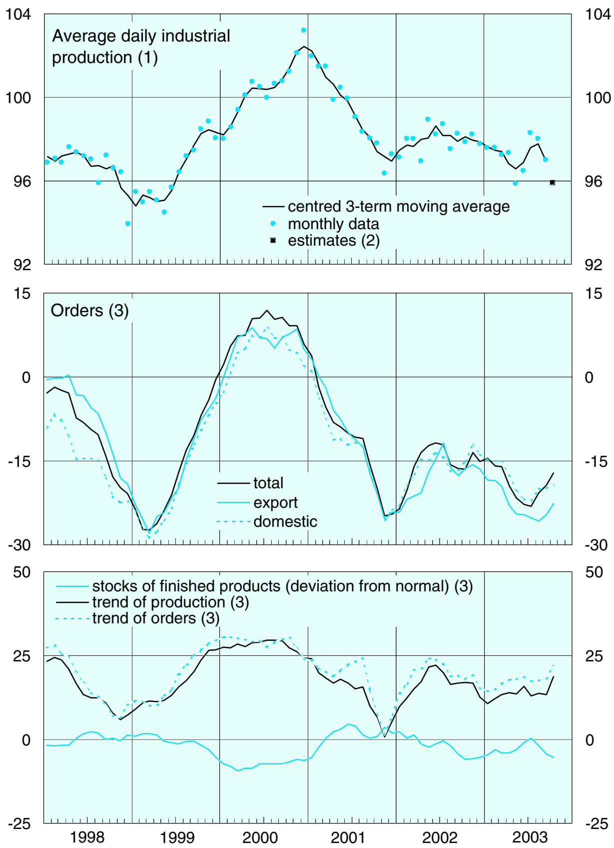
The rise of 4 per cent in investment in construction, which followed one of 4.7 per cent in the second half of 2002, primarily reflected the rapid expansion of non-residential building (6.7 per cent). ANCE, the industry's trade association, expects growth in this segment to be driven by public works in 2003. Residential investment picked up slightly in the first half of the year, from 1 to 1.6 per cent growth, as it continued to benefit from low mortgage rates and tax incentives for renovations and extraordinary maintenance. Real-estate demand remained buoyant, as reflected in the continued rise in prices (11 per cent; about 8 per cent adjusted for consumer price inflation).

According to the Bank of Italy's September survey of industrial and service firms, capital expenditure is likely to be less than that planned at the end of last year. In addition to technical and organizational factors, firms cited unexpected variations in demand and heightened uncertainty as factors in the downward revision.

On the basis of the national accounts, in the first half of the year changes in stocks (which also includes statistical discrepancies) made a large contribution to overall output growth (2.5 percentage points). According to ISAE, the value of stocks of final products gradually rose from the low recorded in the autumn of 2002 to above the level that firms consider normal (Figure 16).

Figure 16

Italy: industrial production, orders and stocks
(monthly data)



Sources: Based on Istat and ISAE data.
(1) Index, 2000=100. Data adjusted for the different number of working days in the month and seasonally adjusted. – (2) Based on electricity consumption and ISAE indicators. – (3) Moving averages for the three months ending in the reference month of the difference between the percentage of positive replies ("high", "increasing") and that of negative replies ("low", "decreasing") to ISAE surveys, not weighted by size of firm. The trend figures refer to the responses for 3-4 months ahead. Seasonally adjusted data except for stocks of finished products.

Exports and imports. – National accounts data show an annualized fall of 11.4 per cent in exports of goods and services at constant prices in the first half of 2003; the decrease with respect to the first half of 2002 was 0.9 per cent. The contraction, which was much more pronounced than in the other main euro-area countries, was concentrated in the first quarter as exports rose slightly in the second (1.8 per cent). Imports fell by 4.5 per cent, reflecting weak domestic demand. Net exports reduced GDP growth by 2.3 percentage points (Table 7).

While world trade in goods grew in the first half of 2003, albeit at a moderate pace, Italian exports continued to lose market share. According to the new Istat foreign trade indices, the volume of goods exports contracted by 2.9 per cent in the first eight months of the year compared with the year-earlier period (Table 8); it had decreased by 4.3 per cent in 2002 as a whole.

Since the end of the 1990s, the price competitiveness of Italian exports has deteriorated more than in the other main European economies. Based on export prices, the loss was 7.5 per cent between the fourth quarter of 2000 and the fourth quarter of 2002, compared with 5.5 per cent in Germany and 3.7 per cent in France. In addition to the euro's nominal appreciation of about 5 per cent over the two-year period, Italy's competitiveness has been eroded by the rapid rise in unit labour costs in industry, which is itself attributable to declining productivity. In the first half of 2003 competitiveness measured on the basis of producer prices (the only indicator available for the period) fell by a further 3.9 per cent, entirely due to the nominal appreciation of the euro (4 per cent; Figure 13).

Table 8

Italian exports and imports *cif-fob* by main countries and areas, January-August 2003: values and indices of average unit values and volumes (1)

(percentage composition of values in 2002 and percentage changes on corresponding period of 2002; indices, 2000=100)

	Exports				Imports			
	Composition	Changes			Composition	Changes		
		Values	Average unit values	Volumes		Values	Average unit values	Volumes
EU countries	**53.6**	**-1.8**	**0.7**	**-3.0**	**57.2**	**1.7**	**2.3**	**-1.3**
of which: France	*12.0*	*-1.3*	*1.7*	*-3.5*	*11.2*	*1.6*	*1.1*	*-0.2*
Germany	*13.5*	*-1.2*	*1.5*	*-3.3*	*17.6*	*1.4*	*1.4*	*-0.7*
United Kingdom	*6.8*	*-2.1*	*-4.5*	*1.7*	*5.0*	*-1.8*	*5.6*	*-8.3*
Spain	*6.3*	*7.9*	*1.6*	*5.5*	*4.5*	*7.1*	*4.9*	*1.4*
Non-EU countries	**46.4**	**-3.5**	**-0.6**	**-2.9**	**42.8**	**1.0**	**. .**	**1.0**
of which: China	*1.5*	*-6.2*	*0.7*	*-8.0*	*3.2*	*17.4*	*-11.5*	*33.0*
Japan	*1.7*	*-4.5*	*-2.1*	*-2.5*	*2.1*	*1.3*	*-0.5*	*1.1*
Russia	*1.4*	*-3.3*	*4.5*	*-7.4*	*3.1*	*7.6*	*5.7*	*1.7*
United States	*9.6*	*-13.0*	*-5.1*	*-8.4*	*4.8*	*-17.6*	*2.6*	*-19.5*
Total	**100.0**	**-2.6**	**. .**	**-2.9**	**100.0**	**1.4**	**1.3**	**-0.3**

Source: Based on Istat data.

(1) The change in values may differ from that derived from changes in average unit values and volumes due to differences between the aggregate for values and that used to calculate average unit values (see the notes to the Appendix tables, Table a18). The change in values for the EU countries and the total is calculated on data corrected for the estimate of some transactions that, starting with 2003, have been observed on an annual rather than monthly basis following changes in the reporting threshold.

According to the Bank of Italy's September survey of the economy, firms have intensified efforts to improve their non-price competitiveness, notably by enhancing the range of products offered in foreign markets.

The decline in export volumes in the first eight months of the year was similar in EU markets (3 per cent) and in the rest of the world (2.9 per cent); the fall with respect to the euro-area economies was 3.7 per cent.

While volumes contracted, prices, proxied by average unit values, remained unchanged overall: an increase of 0.7 per cent in EU markets was offset by a reduction of 0.6 per cent in non-EU markets.

Export volumes declined in all of the sectors in which Italian industry is specialized (Table 9). The Italian model of specialization, which is highly exposed to competition from the emerging economies and poorly represented in the faster growing segments of world demand, continues to slow export growth.

After plunging by 10.4 per cent in 2002, the volume of exports to Germany continued to contract in the first eight months of 2003, although at a slower pace (3.3 per cent with respect to the year-earlier period). Italy continued to lose market shares, especially in fashion and transport equipment. Mechanical engineering sales recovered slightly. In the same period, exports to France declined by 3.5 per cent, falling in all the main sectors. Exports to the United Kingdom started rising again (1.7 per cent); the reduction of 4.5 per cent in average unit values appears to have been aimed at countering the appreciation of the euro against sterling.

In the first eight months of this year the volume of exports to the United States fell by 8.4 per cent, compared with a decline of 1.6 per cent in 2002 as a whole. The contraction reflected the rise of the euro against the dollar, which was only partially offset by the fall of 5.1 per cent in average unit values. Exports to China, which in 2002 represented 1.5 per cent of total Italian exports by value, decreased by 8 per cent in volume terms. However, if a number of large exceptional transactions in the first half of 2002 (repairs of transport equipment) are excluded from the comparison, volumes continued to increase. Exports to the dynamic Asian economies (South Korea, Hong Kong, Malaysia, Singapore, Thailand and Taiwan) were virtually unchanged in volume terms. Sales to these countries rose between January and April but began to decline in May. In the first eight months of the year, exports to the EU acceding countries turned upwards, recording growth of 1.5 per cent, compared with a fall of 3.3 per cent in 2002.

The new foreign trade indices show that Italian imports of goods remained broadly unchanged in the first eight months in volume terms, edging down by just 0.3 per cent on the year-earlier period. Imports of leather and footwear, transport equipment, textiles and clothing, agricultural products, food and beverages increased, while those of chemical products, basic metals and metal products, machinery and equipment and electrical equipment fell (Table 9).

Imports from EU countries decreased by 1.3 per cent. The sharp fall in imports from the United Kingdom (8.3 per cent) was accompanied by a small decline in those from the euro area (0.5 per cent). The volume of imports from non-EU markets began rising again (1 per cent), with increases in nearly all main sectors.

Italy's imports from China continued to accelerate, rising by 33 per cent compared with 21.3 per cent in 2002, while average unit values fell by 11.5 per cent, primarily owing to the appreciation of the euro. The main sectors involved were electronic equipment and precision instruments, textiles and clothing, and "other manufactured goods", which include toys. Over the last decade, China's share of Italy's total imports has more than doubled, reaching 3.2 per cent in 2002 to overtake Japan and the dynamic Asian economies. China's share is much higher in a number of traditional segments (toys and games, bags and travel accessories, textiles and furs), and in optical instruments and photographic equipment and clocks. China's share of total EU imports is slightly smaller, at 2.5 per cent in 2002; in the first half of 2003 the EU's imports from China grew at about the same pace as Italy's.

Table 9

Italian exports an imports *cif-fob* by geographic area and sector of economic activity, January-August 2003: changes in volumes and composition of values

(percentage changes on corresponding period of 2002: indices, 2000=100; percentage composition in 2002)

	Exports						Imports					
	EU		Non-EU		Total		EU		Non-EU		Total	
	Changes	Composition	Changes	Composition	Changes	Composition	Changes	Composition	Changes	Composition	Changes	Composition
Total	**-3.0**	**100.0**	**-2.9**	**100.0**	**-2.9**	**100.0**	**-1.3**	**100.0**	**1.0**	**100.0**	**-0.3**	**100.0**
of which:												
Products of agriculture, forestry and fishing	-4.0	2.2	-2.3	0.8	-3.9	1.5	13.9	3.0	-1.3	4.0	5.6	3.4
Food products, beverages and tobacco	-0.6	6.4	-1.0	4.6	-0.7	5.6	4.5	9.5	4.2	3.7	4.3	7.0
Textile products and clothing	-10.7	9.7	-3.6	11.0	-7.1	10.3	-4.9	2.9	7.8	8.6	4.0	5.4
Leather and leather products	-13.5	3.9	-4.9	6.2	-8.4	5.0	2.7	0.8	11.7	4.7	9.8	2.5
Chemical products and man-made fibres	-0.4	10.7	-7.3	9.3	-3.6	10.1	-4.2	17.7	-10.3	8.1	-6.8	13.6
Basic metals and metal products	. .	9.0	-1.6	6.9	-0.2	8.0	1.7	8.5	-4.3	10.4	-1.2	9.3
Machinery and equipment	-0.3	17.2	-0.3	22.7	-0.2	19.8	-5.4	9.2	7.2	6.0	-1.0	7.8
Electrical machinery and electrical and optical equipment	-7.1	8.9	-2.0	9.7	-4.2	9.3	-6.6	15.8	2.0	9.9	-3.8	13.3
Transport equipment	-3.6	13.1	1.6	9.5	-1.9	11.4	4.5	19.3	-3.8	9.6	2.3	15.1
Other manufactures (including furniture)	-2.3	5.2	-13.6	7.5	-8.0	6.3	-8.3	1.1	12.9	2.2	4.3	1.6

Source: Based on Istat data.

Recent developments. – Following the decreases registered in the first two quarters of the year, preliminary Istat estimates indicate that GDP grew at an annual rate of 2 per cent in the third, the largest rise since the first quarter of 2001. The available cyclical indicators and business surveys point to a modest improvement in economic conditions in the last part of this year.

The Bank of Italy survey of industrial and service firms showed a slight improvement in expectations for demand and industrial output in the fourth quarter. The industrial firms interviewed for the ISAE survey also reported positive assessments of economic developments in the coming months: after a cyclical low in July, the climate of confidence indicator rebounded in August and remained higher in the September and October surveys. The Bank of Italy's September survey of construction firms specialized in public works revealed a favourable outlook for construction in the last quarter of 2003.

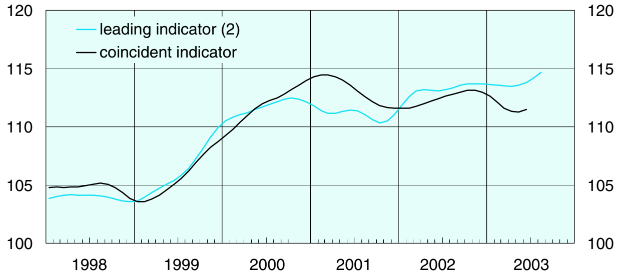
In August the leading indicator of the Italian business cycle, which anticipates economic developments in the subsequent five or six months, confirmed the rising trend that began at the start of the summer, prefiguring an improvement in economic activity in the closing months of the year (Figure 17).

In the third quarter industrial output rose by 1.4 per cent with respect to the previous period, ending the decline under way since the previous autumn. Following the sharp rise in July, activity stagnated in August and contracted in September. Estimates based on electricity consumption suggest the decrease continued in October (Figure 16).

Figure 17

Indicators of the Italian business cycle (1)

(monthly data; indices, 1995=100)



Sources: Based on Istat, ISAE and Bank of Italy data.

(1) The method of constructing the indicators is described in the "Note metodologiche" section of the Appendix to the Bank's Annual Report for 2002 in Italian. – (2) The performance of the indicator leads that of the economy by an average of 5-6 months.

The balance of payments

The euro area. – In the first eight months of the year the euro area's balance-of-payments surplus on current account fell to €2.4 billion, down from €35.5 billion (about €0.8 per cent of GDP) in the same period of 2002. The balance on all the main items deteriorated, with the exception of services (Table 10).

The trade surplus decreased from €85.3 billion to €67.7 billion, the result of a decline of 3.3 per cent in the value of exports and only 0.9 per cent in that of imports. In the first six months of 2003, the period for which data on average unit values are available, the terms of trade worsened by 0.6 per cent: export prices fell by 3.1 per cent and import prices by 2.5 per cent. Both may have been affected by the appreciation of the currency, which may have prompted exporters to reduce their euro prices and lowered the euro value of the foreign currency prices of imported goods.

The deficit on the income account widened from 26.2 billion to €41 billion and that on transfers from 27.9 billion to €34.1 billion; the surplus on services rose from €4.3 billion to €9.7 billion.

In the first eight months the overall balance-of-payments surplus on the current account and capital account amounted to €8.7 billion. The deficit on the financial account came to €69.3 billion, compared with €42.4 billion in the same period a year earlier; this included a decrease of €15.8 billion in official reserves (€2.8 billion in the year-earlier period). Errors and omissions were equal to €60.7 billion, compared with practically nil a year earlier.

The revised data for 2002, which were published in October this year, showed a significant reduction in the previous estimate of errors and omissions, although the amount remains large. The adjustments mainly involved an increase in the liabilities of private non-bank operators and the Eurosystem under "Other investment". The rise in the Eurosystem's liabilities reflects a one-off correction of about €20 billion for all of 2002 to account for the estimated impact of the adoption of the new currency, as the external sector's holdings of banknotes increased at the time of the changeover.

In the first eight months of 2003 net outflows of direct and portfolio investment and financial derivatives totaled €35 billion, compared with net inflows of €3.2 billion in the same period of 2002. While net outflows of direct investment fell from €29.1 billion in the first eight months of 2002 to virtually nil in the same period of 2003, portfolio investment and derivatives swung from a net inflow of €32.4 billion to a net outflow of €34.6 billion.

Reflecting the enduring weakness of economic activity in the main industrial countries and the euro area in particular, direct investment inflows and outflows diminished, as they had in the previous two years. In the eight months to August, residents' investment abroad fell by about 36 per cent from the year-earlier level (from €124.6 billion to €80 billion); foreign investment in the euro area decreased by about 17 per cent (from €95.4 billion to €79.6 billion).

With international conditions for equity investment still unattractive and investors continuing to prefer more liquid instruments, the shift from net

Table 10

Balance of payments of the euro area
(net flows in millions of euros)

	2002			2003	
	H1	January-August	Year	H1	January-August
Current account	**18,047**	**35,494**	**67,020**	**-4,575**	**2,402**
Goods	58,010	85,299	130,617	41,754	67,705
Exports	*522,632*	*697,806*	*1,059,597*	*506,094*	*674,900*
Imports	*464,623*	*612,509*	*928,982*	*464,341*	*607,195*
Services	939	4,317	11,336	5,916	9,724
Income	-19,348	-26,211	-28,243	-29,943	-40,964
Current transfers	-21,554	-27,910	-46,690	-22,302	-34,064
Capital account	**6,421**	**7,444**	**10,894**	**3,778**	**6,257**
Financial account	**4,922**	**-42,378**	**-97,217**	**-66,479**	**-69,314**
Direct investment	-24,654	-29,141	-41,497	4,519	-396
outward	*-109,735*	*-124,585*	*-183,504*	*-66,535*	*-79,960*
inward	*85,079*	*95,441*	*142,005*	*71,055*	*79,564*
Portfolio investment	41,559	40,686	103,427	49,207	-24,302
Equity securities	26,423	30,227	50,577	12,640	11,293
assets	*-44,386*	*-45,417*	*-40,179*	*-21,545*	*-29,982*
liabilities	*70,809*	*75,644*	*90,756*	*34,185*	*41,275*
Debt instruments	15,138	10,461	52,849	36,570	-35,592
assets	*-75,035*	*-96,076*	*-133,729*	*-122,026*	*-155,122*
liabilities	*90,173*	*106,537*	*186,578*	*158,596*	*119,530*
Financial derivatives	1,673	-8,332	-10,227	-5,289	-10,280
Other investment	-17,304	-48,439	-146,647	-128,781	-50,147
Reserve assets	3,644	2,844	-2,277	13,866	15,812
Errors and omissions	**-29,389**	**-559**	**19,304**	**67,275**	**60,654**

Source: ECB.

portfolio investment inflows of €40.7 billion in the first eight months of 2002 to net outflows of €24.3 billion in the same period this year stemmed mainly from the growth in euro-area residents' purchases of foreign bonds and money market instruments. Equity investment inflows decreased from €75.6 billion to €41.3 billion and outflows from €45.4 billion to €30 billion. Residents' purchases of foreign bonds and money market instruments rose from €96.1 billion to €155.1 billion, while foreigners' purchases in the euro area increased from €106.5 billion to €119.5 billion.

Net outflows under "Other investment" amounted to €50.1 billion, compared with €48.4 billion in the first eight months of 2002. Lending by monetary and financial institutions increased in both directions; the balance shifted from a net outflow of €30.8 billion to a net inflow of €4.7 billion.

The balance of payments on current account deteriorated in France, Germany and Spain. In the first eight months of 2003, the surplus in France contracted from €18.3 billion to €8.8 billion and that in Germany from €30.8 billion to €21.8 billion; in Spain the deficit widened from €7.2 billion to €11.7 billion in the first seven months of the year. In France the balances for all of the main current account items worsened; in Germany the main development was the increase in the deficit on income; in Spain the deficits on both goods and income rose. Flows of foreign direct investment were virtually unchanged or diminished further in both directions. In France, net outflows increased, while net inflows rose in Germany and Spain. Outflows of foreign direct investment fell substantially in Germany and Spain but remained broadly unchanged in France. France and Spain recorded net outflows on portfolio investment and derivatives, while there were net inflows in Germany, where, unlike the other two countries, flows of investment in bonds and money market instruments diminished in both directions.

Italy. – The balance of payments on current account has deteriorated sharply in Italy. In the first nine months of 2003 the deficit rose to about €15 billion (around 1.7 per cent of GDP) from €3.4 billion (0.4 per cent of GDP) in the same period of 2002 (Table 11). The trade surplus fell from €13.3 billion to €3.1 billion. The deficit on income rose from €11.6 billion to €13.7 billion and that on transfers from €3.3 billion to €4.7 billion. By contrast, the deficit on trade in services, which was €1.9 billion in the first nine months of 2002, disappeared.

Exports of goods decreased by 4.1 per cent in value terms; imports *fob* increased by 1.2 per cent. In the first eight months of 2003, the period for which data are available, the terms of trade deteriorated by 1.3 per cent. Average unit values of exports were unchanged while those of imports increased by 1.3 per cent. The lack of movement in the former was the net result of a small reduction in prices on markets outside the euro area, partially offsetting the appreciation of the euro and a slight rise in prices within the area. The rise in the unit values of imports was the result of a significant increase in the euro prices of oil in the first half of the year and higher prices for imported manufactures.

The deficit on services was erased thanks to an increase of €1.6 billion in receipts (3.3 per cent) and a reduction of €0.3 billion in spending abroad (0.7 per cent). The disaggregated figures available for the first six months of the year show a deterioration in the balances on foreign travel, insurance, and royalties and licences, which was offset by the improvement in the other items (transport, communications, construction, financial services, computer and information services, personal services and services for government, and other business services).

The surplus on foreign travel slipped from €7 billion to €6.1 billion in the first eight months of the year. The increase of 4.7 per cent in spending abroad stemmed in part from a rise of 2.7 per cent in the number of Italian travellers, while the fall of 1.2 per cent in receipts was attributable to a decline of 2.4 per cent in the number of foreign visitors.

Italian spending on foreign holiday travel, along with business travel one of the two main travel categories, rose by 9 per cent, although spending per person fell as the number of travellers increased by 10.7 per cent; expenditure by foreign holiday-goers in Italy diminished by 1.6 per cent, while their number decreased by 2 per cent. The increase in the number of Italians travelling abroad on holiday was mainly concentrated in travel to the Americas (the United States and Latin America), boosted by the appreciation of the euro. Holiday travel fell sharply to areas affected by the SARS epidemic, especially China and Canada. The number of foreign travellers from the American continent and Asia, (especially Japan and China) decreased, while that from other EU countries was broadly unchanged.

Total expenditure for business travel abroad fell by 1.9 per cent, while the number of Italian business travellers dropped by 3.1 per cent; expenditure by foreign business travellers to Italy fell by 11.1 per cent, while their numbers decreased by 10.5 per cent. In addition to the impact of the general economic slowdown, it is possible that SARS also played a role.

Table 11

Italy's balance of payments (1)
(net flows in millions of euros)

	2002			2003	
	H1	January-September	Year	H1	January-September
Current account	**-6,335**	**-3,427**	**-7,318**	**-16,269**	**-15,265**
Goods	6,746	13,312	17,297	-1,060	3,069
Exports	*131,052*	*197,311*	*268,339*	*126,047*	*189,204*
Imports	*124,306*	*183,999*	*251,042*	*127,107*	*186,135*
Services	-3,185	-1,892	-3,657	-1,495	63
Income	-8,531	-11,597	-15,396	-10,779	-13,684
Current transfers	-1,366	-3,250	-5,561	-2,936	-4,714
Capital account	**909**	**900**	**838**	**301**	**540**
Financial account	**5,426**	**5,637**	**8,538**	**16,360**	**15,406**
Direct investment	-1,429	-3,734	-2,739	-1,350	-3,367
outward	*-8,375*	*-13,049*	*-18,194*	*-11,790*	*-12,347*
inward	*6,946*	*9,315*	*15,455*	*10,440*	*8,980*
Portfolio investment	-13,699	5,453	16,107	25,461	25,935
Equity securities	-18,727	-12,189	-13,194	-13,282	-12,640
assets	*-8,437*	*-6,005*	*-6,039*	*-1,941*	*-7,842*
liabilities	*-10,289*	*-6,184*	*-7,155*	*-11,341*	*-4,798*
Debt instruments	5,028	17,642	29,301	38,743	38,575
assets	*-7,336*	*-10,377*	*-10,929*	*-26,175*	*-39,592*
liabilities	*12,363*	*28,019*	*40,230*	*64,918*	*78,167*
Financial derivatives	94	-949	-2,710	-3,639	-3,699
Other investment	19,713	6,211	991	263	1,930
Reserve assets	747	-1,344	-3,111	-4,375	-5,393
Errors and omissions	**..**	**-3,111**	**-2,058**	**-392**	**-681**

(1) For July, August and September 2003, provisional data.

The deficit on the income account increased by €2.1 billion; in the disaggregated figures for the first six months of the year the deterioration amounted to €2.2 billion, of which €0.4 billion was attributable to compensation of employees and €1.9 billion to investment income. Receipts of investment income rose by 3.7 per cent, while outflows increased by 8.9 per cent. In particular, the deficit on portfolio income widened from €6.4 billion to €8.3 billion; receipts declined and outflows increased, reflecting Italy's increased net portfolio investment liability position.

In the first nine months of the year the overall deficit on current and capital account amounted to €14.7 billion; it was offset by a surplus of €15.4 billion on the financial account (€5.6 billion in the same period of 2002), including an increase of €5.4 billion in the official reserves (€1.3 billion in the year-earlier period). Italy's net external debtor position rose from €73 billion at the end of 2002 to €100 billion at the end of June 2003, equal to 8 per cent of GDP. In addition to the net inflows on the financial account, the deterioration was due to a reduction in the value of foreign assets, largely stemming from exchange rate adjustments – especially for the depreciation of the dollar – that were only partially offset by the rise in international equity markets.

The deficit on foreign direct investment narrowed from €3.7 billion to €3.4 billion. Foreign investment in Italy edged down (from €9.3 billion to €9 billion), as did Italian investment abroad (from €13 billion to €12.3 billion). Disaggregated data for the main sectors of the economy, which are available for the first six months of the year, show that foreign investment in Italy is mainly channeled into banking and insurance services, mechanical engineering and chemicals. Italian investment abroad was concentrated in banking and insurance, mechanical engineering, energy and transport equipment.

Table 12

Foreign portfolio investment in Italy

(millions of euros)

	2002		2003
	H1	Year	H1
Government securities	6,366	24,239	57,985
BOTs	*4,606*	*9,241*	*15,943*
BTPs	*7,704*	*33,125*	*28,141*
CCTs	*-12,765*	*-23,676*	*732*
CTZs	*4,123*	*1,314*	*3,476*
Republic of Italy issues ..	*1,981*	*4,431*	*9,730*
Other government securities	*718*	*-197*	*-37*
Bonds (1)	7,366	18,105	9,142
Bank securities (2)	-1,257	-1,979	-1,283
Equity securities (1)	-10,175	-6,169	-11,940
Other securities (3)	-227	-1,121	-327
Total	**2,074**	**33,075**	**53,577**

(1) The items "Bonds" and "Equity securities" refer to securities issued by residents belonging to non-bank sectors other than general government. – (2) Comprise shares and bonds issued by Italian banks. – (3) Includes units of investment funds.

Net inflows of portfolio investment rose to €25.9 billion in the first nine months of the year, compared with €5.5 billion in the year-earlier period. The behaviour of the main categories of instruments largely mirrored that observed for the euro area as a whole. Flows of portfolio investment in equities remained small, although Italian investment abroad in shares rose from €6 billion to €7.8 billion and foreign disinvestment diminished from €6.2 billion to €4.8 billion. By contrast, inward and outward flows of investment in bonds and money market securities increased significantly. Italian purchases abroad rose from €10.4 billion to €39.6 billion and non-residents' investments in Italy went from €28 billion to €78.2 billion. According to the figures available for the first six months, purchases of Treasury securities by foreigners continued the rise that began in the second half of last year after they had fallen to very low levels between 1999 and the first half of 2002. New investment in Treasury securities rose to about 58 billion, with flows being channeled into all the main categories of securities, chiefly Treasury bonds (€28.1 billion), Treasury bills (€15.9 billion) and Republic of Italy issues (€9.7 billion). Net investment in Treasury credit certificates also resumed (€0.7 billion) after net disinvestment in the previous two years (Table 12).

The net balance of the item "Other investments" fell from €6.2 billion in the first nine months of 2002 to €1.9 billion in the same period this year. The banking system's transactions with the rest of the world gave rise to net inflows of €40.9 billion, compared with net outflows of €32.7 billion in the same period of the previous year. The available information indicates that the reversal was due to net repayments of Italian foreign loans and a net increase in borrowing from abroad. Resident banks' foreign assets in respect of deposits and loans recorded net inflows of about €7.1 billion (compared with net outflows of €13 billion the previous year); net inflows of liabilities rose from €2.3 billion to €29 billion. In 2002 bank outflows offset net inflows of deposits and loans by private non-bank residents, largely ascribable to the effects of Decree Law 350/2001 (the asset repatriation scheme). This trend came to a halt in January 2003: in the first six months of this year, private non-bank residents registered net outflows of assets in respect of deposits and loans amounting to €4 billion, compared with net inflows of €32.3 billion in the same period of 2002; inflows of external liabilities in respect of deposits and borrowing declined from €3.5 billion to €1.6 billion.

The labour market

Employment

With the halt to the expansion of economic activity in the euro area in the first half of 2003, the growth of employment stalled as well. Preliminary national accounts figures indicate that the average number of persons in work during the first six months of the year was the same as in the first half of 2002. This ended the prolonged expansion that began in 1995, which had increased employment in the area by almost 12 million workers (10.5 per cent) and lowered the unemployment rate from 10.8 to 8.8 per cent. Total employment showed an increase of 8 million or 6.6 per cent compared with the previous cyclical peak in 1991, but the labour force had expanded even more strongly, so that unemployment was nearly one percentage point higher (8.8 as against 7.9 per cent).

The slackening in the demand for labour during the first half did not affect all the large economies uniformly (Figure 18).

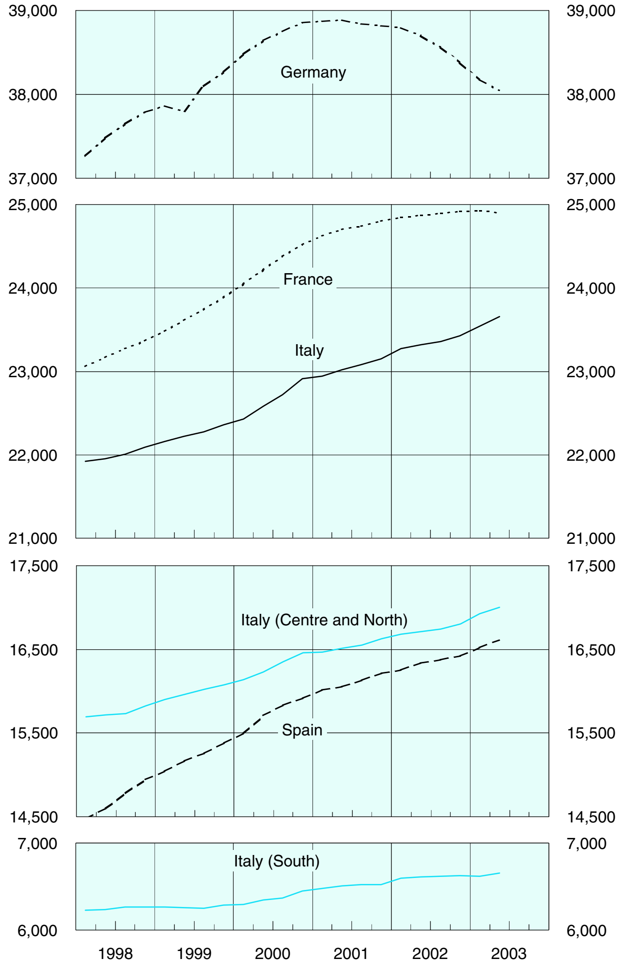
In Germany the decline in the number of persons employed steepened (down 1.6 per cent by comparison with the first half of 2002), representing a total reduction of 770,000 (2 per cent) since the peak in the first half of 2001. In France, by contrast, employment rose but only very marginally (0.2 per cent), and the national accounts indicate a decline in the demand for labour in the second half. In Spain, employment resumed rapid growth (1.7 per cent), sustained by the robust expansion of economic activity, and appears to have overcome the slowdown registered between the end of 2001 and the summer of 2002.

In Italy, despite the weakening of economic growth, the number of persons employed continued to increase in the first half of 2003 (1.3 per cent, or 301,000 jobs; the number of standard labour units increased by 1 per cent). Once again labour demand grew more than value added. Output per standard labour unit fell by another 0.3 percentage points by comparison with the first half of 2002. The elasticity of employment with respect to value added, measured ex-post, remained historically high (1.7 in the first half).

Figure 18

Employment in the main euro-area countries

(seasonally adjusted quarterly data; thousands of persons)



Sources: For Italy, Istat, national accounts and regional estimates; the quarterly segments are partly estimated. For the other countries, Eurostat and national accounts.

By age, the sharpest employment increase this year involved people older than 50. This has been

Table 13

Labour force status of the Italian population

(*thousands of persons and percentages*)

	2001 average (1)		2002 average (1)		January-July average 2002		January-July average 2003	
	Number	Percentage share (2)	Number	Percentage share (2)	Number	Percentage share (2)	Number	Percentage share (2)
Employees	**15,517**	**72.1**	**15,850**	**72.6**	**15,821**	**72.6**	**16,022**	**72.7**
open-ended contracts	14,003	65.1	14,287	65.4	14,271	65.5	14,467	65.7
full-time	13,083	60.8	13,301	60.9	13,285	61.0	13,453	61.1
part-time	920	4.3	986	4.5	986	4.5	1,014	4.6
fixed-term contracts	1,514	7.0	1,563	7.2	1,550	7.1	1,555	7.1
full-time	1,045	4.9	1,104	5.1	1,095	5.0	1,095	5.0
part-time	469	2.2	459	2.1	455	2.1	460	2.1
Self-employed	**5,997**	**27.9**	**5,980**	**27.4**	**5,974**	**27.4**	**6,010**	**27.3**
full-time	5,570	25.9	5,555	25.4	5,547	25.5	5,606	25.4
part-time	427	2.0	425	1.9	427	2.0	404	1.8
Total persons in work	**21,514**	**100.0**	**21,830**	**100.0**	**21,795**	**100.0**	**22,032**	**100.0**
men	13,454		13,594		13,578		13,670	
women	8,060		8,236		8,217		8,362	
Unemployed	**2,267**		**2,163**		**2,167**		**2,111**	
Labour force	**23,781**		**23,993**		**23,962**		**24,143**	
men	14,520		14,610		14,595		14,674	
women	9,261		9,383		9,367		9,469	
Non-labour force	**33,567**		**33,482**		**33,513**		**33,337**	
non-working age (under 15)	8,265		8,270		8,270		8,270	
working age (15-64)	15,336		15,137		15,169		14,983	
not actively seeking work but would be immediately available	*1,175*		*1,125*		*1,143*		*1,105*	
non-working age (65 and over)	9,966		10,074		10,074		10,084	
Population	**57,348**		**57,474**		**57,474**		**57,480**	
Unemployent rate	**9.5**		**9.0**		**9.0**		**8.7**	
men	7.3		7.0		7.0		6.8	
women	13.0		12.2		12.3		11.7	
Participation rate (ages 15-64)	**60.4**		**61.0**		**60.9**		**61.4**	
men	73.6		74.0		73.9		74.4	
women	47.3		47.9		47.8		48.4	
Employment rate (ages 15-64)	**54.6**		**55.4**		**55.3**		**55.9**	
men	68.1		68.8		68.7		69.2	
women	41.1		42.0		41.9		42.7	

Source: Istat, labour force surveys.
(1) Average of the surveys taken in January, April, July and October. – (2) Of total employment.

the pattern since 1999, presumably because of the progressive raising of the age of eligibility for seniority pensions under the Dini reform (Law 335/1995; see the box *The composition of employment by age and pension legislation in the last ten years*). Another contributory factor to the increase in employment this year may have been the further easing of the limits to cumulability of pension with labour income under the Finance Law for 2003 (Article 44).

Istat's quarterly labour force survey in July found 22,215,000 persons employed, the same as in April and 231,000 (1 per cent) more than in July 2002. There was a comparable expansion of 236,000 or 1.1 per cent in the first half by comparison with the first half of 2002 (using the average of the January, April and July surveys). The employment rate for the population aged 15-64 rose by 0.6 percentage points to 55.9 per cent (Table 13).

Three fifths of the employment increase in the first half was accounted for by women; the number of women in work rose by 145,000 or 1.8 per cent. Despite the strong gains of recent years, at 42.7 per cent (up from 35.8 per cent in 1993) Italy's female employment rate remains lower than the EU average (55.5 per cent in 2002).

Most of the employment gain involved payroll employees (200,000 jobs), and virtually all of these were open-ended positions. The number of workers on fixed-term contracts remained unchanged at 1.55 million, thus declining from 9.8 to 9.7 per cent of total payroll employment (Table 13a). This shift in the composition of the work force continues to be encouraged by incentives for open-ended hiring.

Part-time work continued to increase. In the first half of 2003, 9.2 per cent of payroll employees were on part-time contracts, compared with 9.1 per cent a year earlier (Table 13a). The increase involved women (from 17.3 to 17.9 per cent), workers aged 35 and older and workers in the service sector.

Employment rose in all branches of the economy except agriculture, where it declined by 2.7 per cent in the first half of the year when calculated as the average of the January, April and July surveys (Table 13b). In the service sector the number of persons employed rose by 1.2 per cent or 170,000, although on a seasonally adjusted basis it was the same in July as in April. Cyclical indicators for the second half of the year give disparate results. According to ISAE business surveys, in September most retailers expected to reduce staff in the following quarter, while large-scale distributors expected to expand. In August the service firms with more than 500 employees responding to ISAE's survey of large companies reported positive developments in demand for labour.

Table 13a

Fixed-term and part-time employees' share of total payroll employment in Italy

(percentages; average of January, April and July surveys)

	Fixed-term		Part-time	
	2002	2003	2002	2003
Men	8.4	8.1	3.4	3.1
Women	11.9	12.0	17.3	17.9
Aged 15-34	15.6	15.7	10.0	9.9
35 and over	6.2	6.0	8.5	8.8
Agriculture	36.7	35.8	18.1	15.4
Industry excluding construction	6.3	6.1	5.0	5.0
Construction	12.8	11.6	3.9	3.9
Services	9.8	9.9	11.0	11.3
of which: wholesale and retail trade and hotels	*12.0*	*11.8*	*15.0*	*15.5*
Total economy	**9.8**	**9.7**	**9.1**	**9.2**

Source: Istat, labour force surveys.

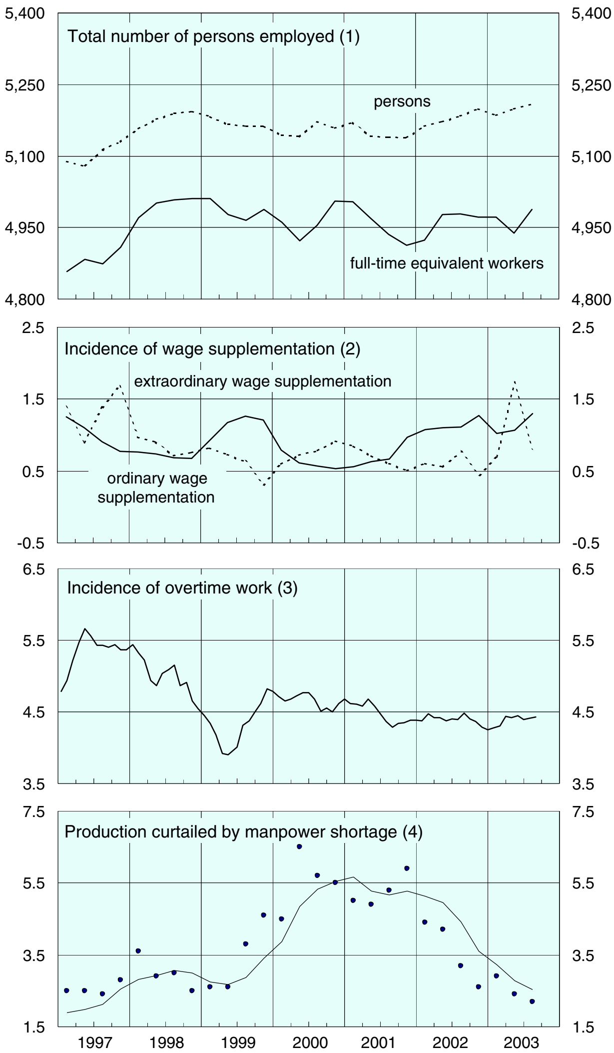
In construction the employment expansion under way since 1999 continued. In the first half the number of workers rose by 77,000 or 4.5 per cent, the gain being registered only in the January and especially the April surveys. The expansion halted in the second quarter and employment fell by 0.3 per cent between April and July, partly because of the scheduled termination of tax incentives for building renovation. However, the Finance Bill for 2004, now before Parliament, provides for their reinstatement.

In industry excluding construction, the number of workers was 19,000 or 0.4 per cent higher in the first half than a year earlier despite the contraction of activity (Figure 19). Since October 2001 when the current employment expansion began, the number of persons employed in industry has risen by 70,000 or 1.4 per cent, while the sector's value added has diminished by 1.2 per cent.

Figure 19

Employment, wage supplementation and overtime work in industry excluding construction in Italy

(seasonally adjusted data; thousands of persons and percentages)



Sources: Based on Istat, labour force surveys and *Indagine sulle grandi imprese,* and on INPS and ISAE data.

(1) Data refer to the January, April, July and October surveys. The number of full-time equivalent workers is obtained by considering two part-time workers to be equal to one full-time worker and subtracting the number of workers equivalent to the number of man-hours of wage supplementation granted. – (2) Average number of equivalent employees on ordinary or extraordinary wage supplementation during the quarter as a percentage of the number of full-time equivalent workers. – (3) Monthly data. Total number of overtime hours as a percentage of total number of regular hours in industrial companies with at least 500 employees. Moving averages of the three months ending in the reference period. – (4) Companies so reporting as share of total; percentages and moving averages of the four quarters ending in the reference quarter.

In the South of Italy the growth of employment came to a halt in the first half of 2003 after rising faster than in the rest of the country for two years. Employment continued to expand in the Centre and the North, by 1.6 and 1.5 per cent respectively.

Table 13b

Employment by sector and geographical area in Italy, 2003

(unadjusted)

	July 2003	Average for Jan.-Apr. 2003 on corresponding period 2002			July 2003 on April 2003 (1)
	Percentage share of national total	Absolute change	Percentage change	Contribution, percentage points	Percentage change
Sector					
Agriculture........	4.9	-29,798	-2.7	-0.1	-1.4
Industry excl. construction...	23.6	19,166	0.4	0.1	0.2
Construction.....	8.2	77,376	4.5	0.4	-0.3
Services...........	63.3	170,220	1.2	0.8	..
Geographical area					
North................	51.4	168,990	1.5	0.8	-0.1
Centre..............	20.3	68,495	1.6	0.3	0.1
South...............	28.3	-521	..	..	..
Italy..........	**100.0**	**236,964**	**1.1**		**..**

Source: Istat, labour force surveys.
(1) Seasonally adjusted.

Unemployment and labour supply

In the euro area the seasonally adjusted unemployment rate continued to rise until March and then steadied at 8.8 per cent (Figure 20). In September (the latest data available) it was 0.4 points higher than in September 2002. The increase involved all the area's economies with the significant exceptions of Spain and Italy.

The composition of employment by age and pension legislation in the last ten years

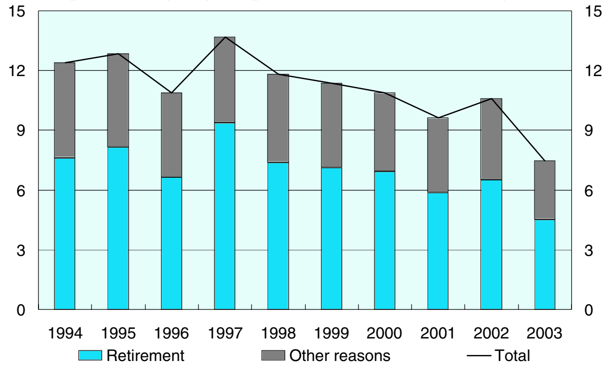
The rise in employment in recent years under the impulse of wage moderation and increased labour flexibility has been accompanied by a shift in the composition of the labour force towards older workers. In 2003, workers aged between 52 and 64 accounted for 16.2 per cent of total employed persons aged 15 to 64, compared with 14.6 per cent in 1997.[1] Between 2000 and 2003, the number of employed persons aged 52 to 64 increased by 4 per cent a year, while that of employed persons aged 15 to 51 rose by 1 per cent. Persons aged 52 to 64 contributed 0.6 percentage points to the annual rise of 1.5 per cent in total employment (see table). Factors in the shift were demographic developments and successive amendments of pension legislation in the last decade,[2] which have gradually raised the retirement age and contribution requirements for seniority and old-age pensions.

For the group aged 52 to 64, the annual change in employment can be broken down into two components. The first is that attributable to "generational turnover", namely the difference between the number of those entering this group (i.e. employed persons who turn 52) and those exiting it (those who turn 65). The second is the change in the number of employed persons between 53 and 64 years of age due to persons leaving employment as a result of unemployment, retirement, disability or other causes, net of persons re-entering employment. This component has a structurally negative impact on employment because the number of persons exiting far exceeds re-entries.

As the eligibility requirements for old-age and seniority pensions have tightened the number of persons leaving employment has fallen significantly (see figure). In 1994, for every 100 employed persons aged 53 to 64, just over 12 left work without taking a new job (of which 8 retired on old-age or seniority pensions). These figures changed only marginally in the subsequent three years[3] before beginning a steady decline in 1998. The fall in exits is almost entirely attributable to the decrease in the number of retirements, which fell from an average of 7.9 per cent between 1993 and 1997 to 4.5 per cent in 2003.

Percentage of persons aged 53 to 64 leaving employment (1)

(as a percentage of employment in the same age class)



Source: Istat, labour force surveys.

(1) For 2003, average of January, April and July surveys.

As regards the relative weight of the two components, generational turnover made a positive contribution of 1.5 percentage points in 1994. This rose to 2 points for the period between 2000 and 2003 (see table). In 1994 and 1995, net exits of workers aged 53 to 64 contributed about 2 percentage points a year to the decline in employment. From 1997 to 1999, in conjunction with the raising of the minimum retirement age from 52 to 55 for private-sector employees, the negative contribution of net exits declined from 1.8 to 1.4 points; it has been 1.3 points in the last two years.

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[1] *Average of Istat's January, April and July labour force surveys.*

[2] *The main legislative changes are contained in Legislative Decree 503 of 30 December 1992 (the Amato Law), Law 537 of 24 December 1993, Law 724 of 23 December 1994, Law 335 of 8 August 1995 (the Dini Reform) and Law 449 of 27 December 1997 (the Prodi Reform).*

[3] *The temporary fall in persons leaving employment in 1996 came in conjunction with the introduction of the minimum retirement age of 52 years with the Dini Reform.*

cont. ➤

Number of persons in employment in Italy aged 15-64

(changes in numbers and percentages; contributions in percentage points)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 (1)
Number	-314,837	-130,441	94,237	47,068	249,395	266,665	395,142	416,758	308,678	243,910
Percentage changes	-1.6	-0.7	0.5	0.2	1.3	1.3	1.9	2.0	1.5	1.1
Contribution to percentage changes										
15-51 age group	-1.0	-0.2	0.7	0.7	1.3	0.9	1.3	1.4	0.8	0.4
52-64 age group	-0.6	-0.5	-0.2	-0.5	. .	0.4	0.6	0.6	0.7	0.7
of which:										
"generational turnover" (2)	1.5	1.5	1.4	1.3	1.5	1.9	2.0	2.0	2.0	2.0
"exits" (3)	-1.9	-2.0	-1.6	-1.8	-1.5	-1.5	-1.4	-1.4	-1.3	-1.3
Memorandum item:										
Eligibility requirements for seniority pension (4)										
Private sector employees										
age			52	52	54	55	55	56	57	57
years of contributions			35	35	35	35	35	35	35	35
contributions only	35	35	36	36	36	37	37	37	37	37
Public employees										
age.............................			52	52	53	53	54	55	55	56
years of contributions			35	35	35	35	35	35	35	35
contributions only	35	35	36	36	36	37	37	37	37	37
Self-employed										
age.............................			56	56	57	57	57	58	58	58
years of contributions			35	35	35	35	35	35	35	35
contributions only	35	35	40	40	40	40	40	40	40	40
Eligibility requirements for old-age pension (4)										
age										
men	61	61/62	62	63	63/64	64	65	65	65	65
women	56	56/57	57	58	58/59	59	60	60	60	60
contributions	16	17	17	18	18	19	19	20	20	20

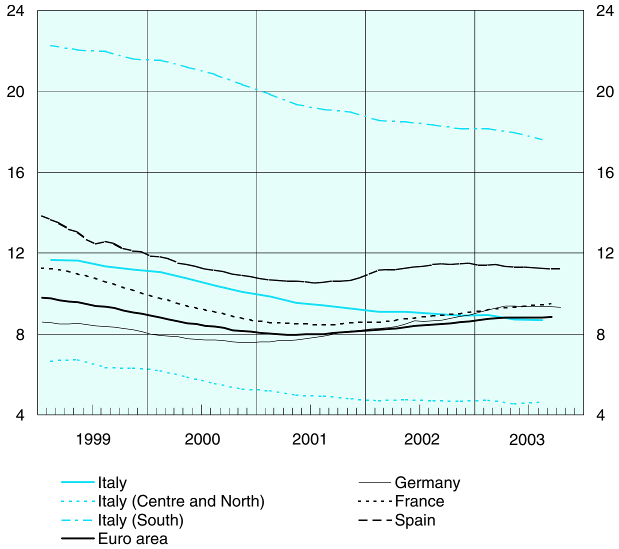
Source: Istat, labour force surveys.

(1) Average of January, April and July surveys. – (2) Difference between the number of persons in employment aged 52 in the year indicated and the number of those aged 64 the previous year. – (3) Difference between the number of persons in employment in the same age cohort in two successive years (for the age cohorts from 53 to 64 years). – (4) Years.

Figure 20

Unemployment rates in the euro area

(seasonally adjusted data; percentages)



Sources: For Italy, quarterly Istat data; for the other countries, monthly Eurostat data.

In Germany the unemployment rate in October was 9.3 per cent, 0.5 points higher than in October 2002. Unemployment rose rapidly until April and then stabilized. There was a more protracted increase in France, where the rate rose to 9.5 per cent in September, 0.6 points higher than a year earlier. The sharpest increases were in Portugal (from 5.4 to 7.4 per cent) and the Netherlands (from 2.9 to 4.2 per cent). Unemployment in Spain fell to 11.2 per cent in October, 0.2 points lower than twelve months earlier.

In Italy the unemployment rate was 8.8 per cent in July, the same as in April but down from 8.9 per cent in January and 9.0 per cent in July 2002. The decrease in the first half of the year by comparison with the year-earlier period was greatest in the South (from 18.3 to 17.9 per cent), less marked in the North (from 4.0 to 3.8 per cent). The regions of the Centre showed a slight rise (from 6.5 to 6.7 per cent). The nationwide rate for men declined from 7.0 to 6.8 per cent, not seasonally adjusted, and that for women from 12.3 to 11.7 per cent.

Italian labour force participation has continued to increase. In the first half of the year the participation rate for the population of working age (15-64) rose to 61.4 per cent from 60.9 per cent in the first half of 2002. For the entire population older than 15, the rate rose from 48.7 to 49.1 per cent. The rate remains far below the EU average (69.7 per cent in 2002). Participation increased only in the Centre and North (from 64.7 to 65.6 per cent) while edging down in the South (from 54.0 to 53.7 per cent), accentuating an already wide regional disparity. Both the male and female participation rates continued to increase, although more slowly than in years past. The former rose from 74.0 to 74.4 per cent as against an EU rate of 78.4 per cent in 2002, the latter from 47.8 to 48.4 per cent (60.9 per cent in the EU in 2002).

Wages, labour costs and industrial relations in Italy, France, Germany and Spain

In the first half of 2003 the rise in per capita labour costs in the four large euro-area economies continued to be modest (2.3 per cent with respect to the first half of 2002, 2.2 per cent in 2002 as a whole; Table 14). Unit labour costs accelerated slightly, as the rate of increase rose to 1.8 per cent as against 1.7 per cent in 2002, in conjunction with a small gain of 0.5 per cent in productivity. In Italy the pace of the increase slowed from 2.9 per cent in all of 2002 to 2.4 per cent in the first half of this year, equalling that in France but remaining much higher than in Germany. Still higher values were registered in Spain.

Italy. – According to the national accounts, in the first six months of 2003 earnings per full-time equivalent employee were 2.2 per cent higher than in the first half of 2002. Real per capita earnings fell by 0.5 per cent when gauged against consumer prices and by 0.4 per cent in terms of the value added deflator.

The smallness of nominal wage increases reflected the slow rise in contractual earnings (2.1 per cent in the first three quarters of the year), which were affected by the late renewal of the wage agreements for metalworkers and wholesale and retail workers (which has still not been signed).

Table 14

Unit labour costs, per capita earnings, productivity and its components

(percentage changes on corresponding period)

	Cost of labour per employee (1)		Productivity						Unit labour cost	
					Value added (2)		Employment (1)			
	2002	H1 2003	2002	H1 2003	2002	H1 2003	2002	H1 2003	2002	H1 2003
					Industry excluding construction					
Germany	1.6	2.9	2.2	4.0	-0.1	0.7	-2.2	-3.2	-0.5	-1.0
France	2.6	3.0	1.9	2.2	0.1	-0.3	-1.7	-2.4	0.7	0.8
Italy	2.6	2.7	-0.4	-1.1	-0.1	-1.3	0.4	-0.2	3.0	3.8
Spain	3.6	4.3	0.7	2.3	0.6	2.4	-0.1	0.1	2.9	2.0
Euro 4 (3)	2.0	2.7	1.2	2.0	0.1	0.3	-1.1	-1.7	0.8	0.7
					Services (4)					
Germany	1.7	2.0	0.7	1.2	1.1	0.5	0.5	-0.7	1.0	0.8
France	3.0	2.6	0.5	-0.1	1.8	0.6	1.3	0.8	2.5	2.7
Italy	2.3	1.9	-0.6	0.1	0.9	1.4	1.5	1.4	3.0	1.9
of which: private ...	*2.1*	*1.8*	*-1.2*	*-0.7*	*0.8*	*1.2*	*2.0*	*2.0*	*3.4*	*2.6*
public	*2.5*	*2.0*	*0.5*	*1.5*	*1.3*	*2.0*	*0.8*	*0.4*	*2.0*	*0.4*
Spain	3.8	3.7	-0.8	-0.5	1.6	2.0	2.4	2.4	4.6	4.1
Euro 4 (3)	2.4	2.3	0.1	0.2	1.3	0.8	1.2	0.6	2.3	2.1
					Total economy					
Germany	1.5	2.2	1.1	1.9	0.4	0.2	-0.6	-1.6	0.5	0.3
France	2.7	2.6	0.8	. .	1.4	0.2	0.6	0.1	1.9	2.5
Italy...........................	2.4	2.1	-0.5	-0.3	0.6	0.8	1.1	1.1	2.9	2.4
Spain	3.9	3.9	0.1	0.4	1.6	2.1	1.5	1.7	3.8	3.5
Euro 4 (3)	2.2	2.3	0.4	0.5	0.9	0.5	0.5	0.0	1.7	1.8

Sources: Based on Istat and Eurostat data.

(1) For Germany and France, persons employed; for Italy and Spain, standard labour units. – (2) At 1995 base prices. – (3) Weighted average for France, Germany, Italy and Spain. – (4) Comprises wholesale and retail trade, transport and telecommunications, financial and real estate intermediation, and "other sectors".

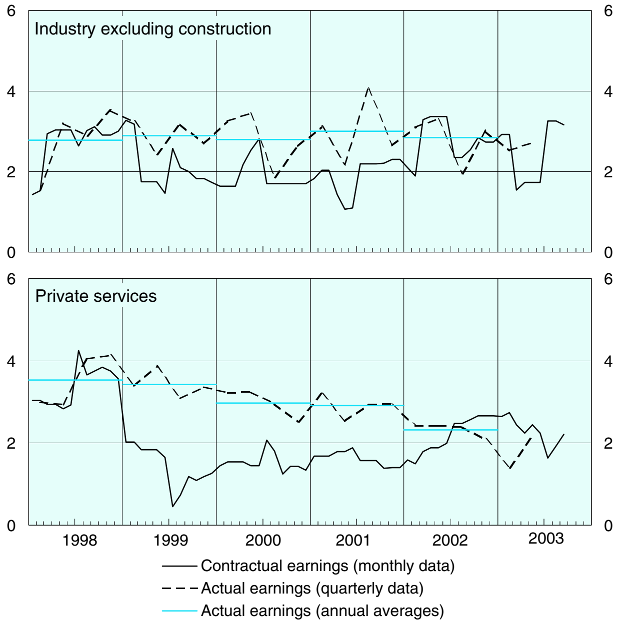
While confirming the policy of wage moderation, the metal and engineering contract, like the others signed in 2003 (railway workers, paper and printing, hotel and restaurant workers, food processing), does not refer to the Government's target inflation rate but to the inflation projections of the leading forecasting institutions.

In industry excluding construction actual per capita earnings rose 2.7 per cent by comparison with the first half of 2002, 0.7 points more than the rise in contractual earnings (Figure 21). The gap, wider than in the past, was due in part to the one-off payment of €115.00 (equal to 6.2 per cent of the average monthly earnings of industrial workers in 2003) to metalworkers in compensation for the delay in renewing their expired contract and in part to increases negotiated at company level, as was confirmed by the Bank of Italy's survey of industrial and service firms with more than 20 employees. In the third quarter the rate of increase in contractual earnings rose to 3.2 per cent (against 1.7 per cent in the second quarter), due to the first raise under the new metal and engineering contract in July.

Figure 21

Italy: per capita contractual and actual earnings

(seasonally adjusted data; percentage changes on year-earlier period)



Sources: Based on Istat, national accounts and *Indagine sulle retribuzioni contrattuali.*

Per capita labour costs (including employer contributions) in industry excluding construction rose by 2.7 per cent in the first half (Table 14). Given the further decline of 1.1 per cent in labour productivity, the pace of the rise in unit labour costs quickened to 3.8 per cent, from 3.0 per cent for 2002 as a whole. This widened the gap with respect to France, where the increase was 0.8 per cent, and above all with respect to Germany, where unit labour costs fell by 1 per cent.

In the construction industry and the private service sector, per capita earnings rose by 2.1 and 1.8 per cent respectively, which was less than in manufacturing, and the rise in per capita labour costs in the two sectors was significantly more moderate (1.5 and 1.8 per cent respectively). Unit labour costs rose by 2.8 and 2.6 per cent respectively.

Germany. – Per capita labour costs were 2.2 per cent higher in the first half than a year earlier. The increase in industry excluding construction was sharper (2.9 per cent). This increment, which was much greater in real terms than in other European countries, especially in industry, coincided with a sharp gain in labour productivity. Productivity improved by 1.9 per cent for the economy as a whole and 4.0 per cent in industry excluding construction, chiefly reflecting the significant contraction in employment. As a result unit labour costs were nearly unchanged for the economy as a whole (+ 0.3 per cent) and declined by 1 per cent in industry excluding construction.

France. – Per capita labour costs rose 2.6 per cent in the first half of the year for the entire economy. Unit labour costs rose at about the same pace (2.5 per cent), as labour productivity remained basically unchanged. In industry excluding construction, however, productivity gained 2.2 per cent, so that unit labour costs rose by just 0.8 per cent, much less than in the rest of the economy.

Spain. – Per capita labour costs for the entire economy continued to rise much faster than in the other major euro-area economies in the first half (3.9 per cent, as in 2002 as a whole). A modest improvement in productivity (0.4 per cent) slowed the rise in unit labour costs to 3.5 per cent from 3.8 per cent for 2002 as a whole. Unit labour costs continue to rise very rapidly. The disparity vis-à-vis Italy is due entirely to the service sector (4.1 and 1.9 per cent respectively). In industry, by contrast, unit labour costs rose much less than in Italy (2 versus 3.8 per cent).

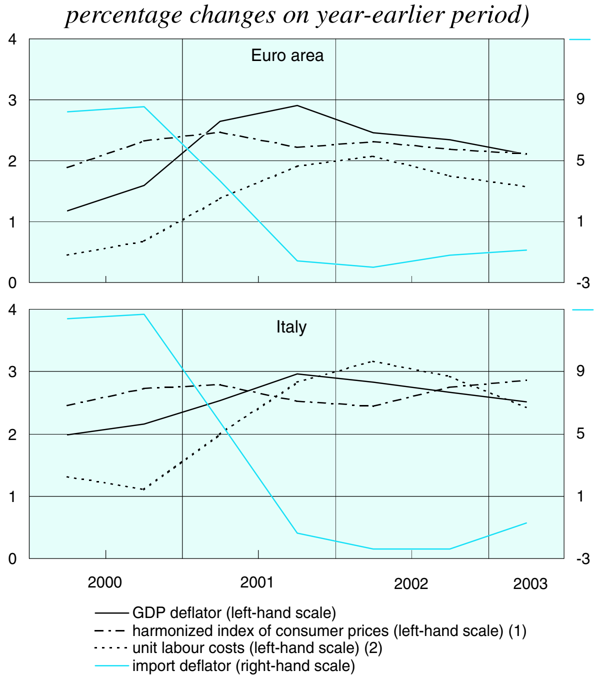
Prices and costs

Overview

In the first nine months of 2003 the average increase in consumer prices on the year-earlier period was 2.1 per cent in the euro area and 2.9 per cent in Italy, compared with 2.3 and 2.6 per cent respectively in 2002. In the euro area the slowdown in inflation can be ascribed to the decline in the core components under way since the middle of 2002 due to domestic cost trends. Among the imported components the further appreciation of the euro offset the rise in dollar price of oil (Figure 22).

Figure 22

Inflation indicators in the euro area and Italy
(half-yearly data; percentage changes on year-earlier period)



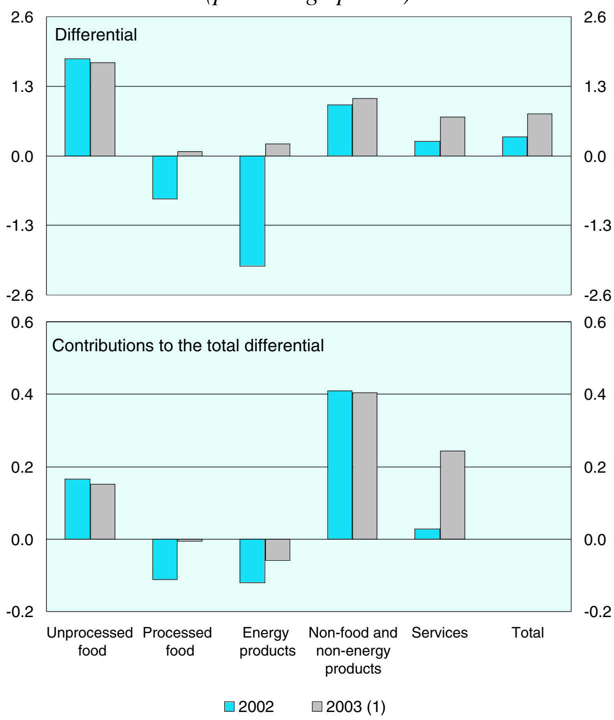
Sources: Based on Istat and Eurostat data.

(1) For the years before 2002, for Italy the percentage changes are calculated with reference to harmonized indices that exclude temporary price reductions. – (2) For the entire economy. Moving averages of the 2 six-month periods ending in the reference one. For the euro area, the changes are calculated on the basis of the figures for France, Germany, Italy and Spain; for Italy and Spain, unit labour costs are based on standard labour units.

Core inflation (the 12-month changes in the harmonized consumer price index net of energy and unprocessed food products) abated in the main euro-area countries but in Italy fluctuated around the 2002 average, mainly owing to the undiminishing rate of increase in the prices of services. The failure of these to slow down is not fully explained by cost trends; unit profit margins in the sector widened in the first half of the year.

Figure 23

Inflation differential between Italy and the euro area
(percentage points)



Source: Based on Eurostat data.
(1) Average for the first nine months.

Partly as a consequence of the divergence in services, the inflation differential between Italy and the euro area grew to 0.8 percentage points on average in the first nine months, compared with 0.3 points in 2002 (Figure 23). As in 2002, the differential reflects larger rises in Italy in the prices of unprocessed food products as well as of non-food and non-energy industrial products due to a worse performance of unit labour costs in industry (and labour productivity in particular) than in the other main countries. The two components accounted respectively for around 0.2 and 0.4 percentage points of the differential.

During 2003 there was no change in the discrepancy already observed in 2002 between the official figures for inflation in Italy and the euro area and consumers' perceptions according to surveys. It is likely that consumers' opinions reflect larger-than-average increases in the prices of frequently purchased goods and services, which are implicitly assigned a greater weight than they actually have in the basket representing the structure of consumption of the population as a whole.

The expectations of professional forecasters and consumers are for a reduction next year in the rate of increase of prices in the euro area and in Italy.

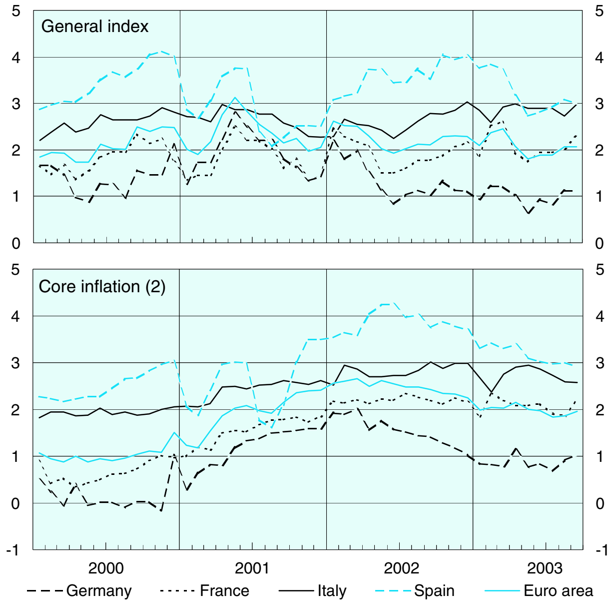
Prices and costs in the euro area

Consumer prices. – The rate of consumer price inflation in the euro area peaked at 2.4 per cent in the first quarter of 2003 and then fell back to around 2 per cent, where it fluctuated slightly, mainly owing to the more volatile components (Figure 24). The prices of energy products, which had risen at the beginning of the year, eased briefly in April and May and then surged again in the summer, when the prices of unprocessed foods rose more than in previous years because of drought.

Core inflation, which had already begun to abate in the first half of 2002, gradually dropped from 2.6 per cent in the first half of 2002 to 2 per cent in the early months of 2003 and then fluctuated around that mark. The slowdown involved all the main euro-area countries but not to the same extent: in the third quarter the rate fell to 3 per cent in Spain, 2 per cent in France and 0.9 per cent in Germany, compared with 3.9, 2.2 and 1.8 per cent respectively in the first half of 2002. In Italy it rose from 2.6 per cent in the first quarter to 2.9 per cent in the second before falling back to 2.6 per cent in the third.

Figure 24

Harmonized index of consumer prices (1)
(*monthly data; twelve-month percentage changes*)



Source: Based on Eurostat data.
(1) For the years before 2002, for Italy the percentage changes are calculated with reference to harmonized indices that exclude temporary price reductions. – (2) General index excluding unprocessed food and energy products.

Among the components of core inflation, industrial goods prices registered the sharpest slowdown; the area-wide rate of growth fell by more than half compared with the first six months of 2002, to 0.7 per cent in the third quarter of this year (Table 15). Prices were curbed by the favourable trend in imported input costs thanks to the rise in the effective exchange rate of the euro and the continuing deceleration in domestic costs. In Germany and France, where the rate of change in industrial prices was already very low in the second half of 2002, it declined further. In Germany it actually turned negative (–0.4 per cent on average in the first nine months) as a result of the sharp drop in the prices of certain durables (such as audio, computer and photographic equipment) that have a higher weight in the basket than they do in the rest of the area. If these products are excluded, the index showed practically no change.

Table 15

Inflation indicators in Italy and the euro area

(percentage changes on year-earlier period)

	Italy							Euro Area						
	2002	2003 (1)	2002		2003			2002	2003 (1)	2002		2003		
			Q3	Q4	Q1	Q2	Q3			Q3	Q4	Q1	Q2	Q3
Consumer prices (1)														
General index	2.6	2.9	2.6	2.9	2.8	2.9	2.9	2.3	2.1	2.1	2.3	2.3	1.9	2,0
Excluding unprocessed food and energy products	2.8	2.7	2.9	3.0	2.6	2.9	2.6	2.5	2.0	2.5	2.3	2.0	2.0	1,9
of which: non-food and non-energy products	*2.4*	*1.8*	*2.4*	*2.6*	*1.7*	*2.2*	*1.7*	*1.5*	*0.8*	*1.3*	*1.2*	*0.7*	*0.9*	*0,7*
services	*3.4*	*3.3*	*3.5*	*3.5*	*3.5*	*3.3*	*3.2*	*3.1*	*2.6*	*3.3*	*3.1*	*2.7*	*2.6*	*2,5*
Producer prices														
General index	0.2	1.8	0.6	1.7	2.7	1.7	1.2	0.0	1.7	0.0	1.3	2.5	1.5	1,3
Excluding food and energy products	1.1	1.3	1.3	1.7	1.7	1.4	0.7	0.5	0.8	0.7	1.1	1.1	0.9	0,4
of which: final consumption goods excl. food and energy products	*2.5*	*1.3*	*2.5*	*2.5*	*1.5*	*1.4*	*0.9*	*1.5*	*1.1*	*1.7*	*1.5*	*1.3*	*1.2*	*0,8*
Unit labour costs (2)														
Total economy	2.9		2.9	2.0	2.0	2.8		1.8		1.8	1.1	1.6	1.9	
of which: industry excl. construction	*3.0*		*3.1*	*3.2*	*3.5*	*4.2*		*0.8*		*0.9*	*-0.4*	*0.3*	*1.1*	
services	*3.0*		*2.7*	*1.3*	*1.5*	*2.3*		*2.3*		*2.2*	*1.7*	*2.0*	*2.2*	

Source: Based on Eurostat data.
(1) Average for the first nine months – (2) For the euro area, the changes are calculated on the basis of the figures for France, Germany, Italy and Spain; for Italy and Spain, unit labour costs are based on standard labour units.

In 2003 the tensions in the service sector stemming from the euro cash changeover subsided. The average rate of price increase in the euro area dropped to 2.5 per cent in the third quarter, compared with 3.1 per cent in the first half of 2002. It declined in all the main countries but only marginally in Italy.

As a consequence of the fairly uniform trends of the core components, the dispersion of rates of inflation within the euro area diminished slightly during the year. Measured in terms of standard deviation, it fell from 1.2 percentage points in the first quarter to 1 point in the third.

Preliminary figures for October in Italy and Germany show twelve-month rises in the harmonized consumer price index of 2.8 and 1.2 per cent respectively. Eurostat estimates the average inflation rate for the area at around 2.1 per cent.

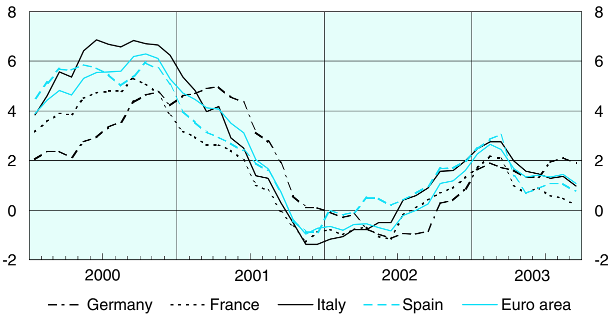
Producer and export prices. – In the first nine months of 2003 the twelve-month rate of change in producer prices in the euro area was higher than in 2002 (1.7 per cent compared with no change in 2002). This was partly due to the end of the downward effect of the energy component (Table 15 and Figure 25). Excluding energy and food products, producer price inflation remained moderate at 0.8 per cent compared with 0.5 per cent in 2002.

During the year the growth rate of producer prices declined from 2.5 per cent in the first quarter to 1.3 per cent in the third, reflecting the deceleration of intermediate goods prices. The rise in the prices of energy products from the summer onwards as oil prices picked up was countered by the good performance of prices of other raw materials.

Figure 25

General index of producer prices (1)

(twelve-month percentage changes)



Source*:* Eurostat.

(1) The index refers to the prices of manufactured goods. Owing to differences of method the indexes of the various countries are not entirely comparable.

The twelve-month rate of change in the producer prices of non-food and non-energy consumer products, which had fluctuated around 1.5 per cent in 2002, edged down to an average of 0.8 per cent in the third quarter of 2003. Performances diverged among the main countries: in Germany prices actually fell, year-on-year, until the beginning of the summer and then remained virtually stationary; in Italy the twelve-month rate of increase gradually slowed from 1.5 per cent in the first quarter to 0.9 per cent in the third, and in France from 0.7 to 0.3 per cent; in Spain it held fairly steady at around 2.5 per cent.

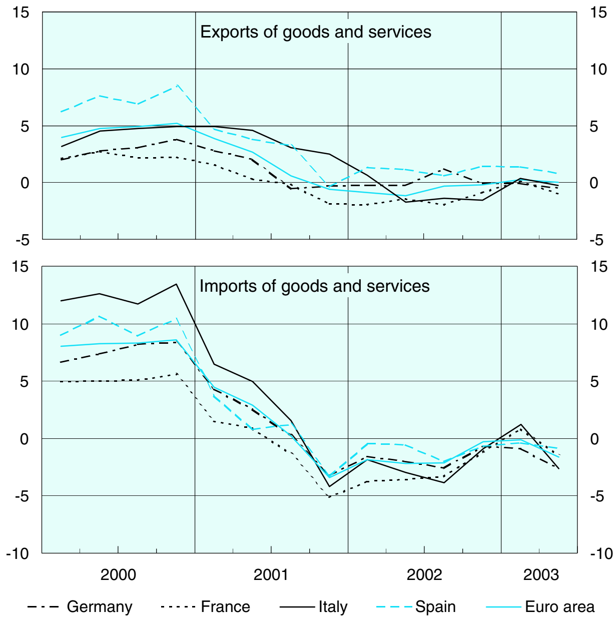
In the present weak economic context, according to the survey conducted by the European Commission in October the responses of manufacturing firms in the euro area concerning their pricing policies confirm the virtual absence of inflationary pressure in the short term.

The slack growth in world demand and the appreciation of the euro curbed export prices in the main euro-area countries. According to national accounts data, in the first half of 2003 the average implicit deflator for exported goods and services declined in Germany and France by 0.3 and 0.4 per cent respectively compared with the year-earlier period. In Italy it showed almost no change owing to greater pressures on prices coming from domestic costs (Figure 26).

Figure 26

Export and import deflators

(percentage changes on year-earlier quarter)



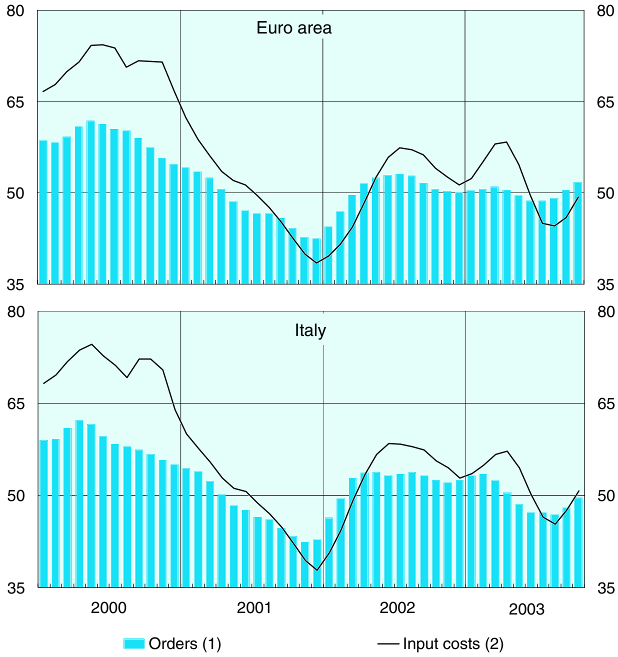
Sources*:* Based on Eurostat and Istat data.

Costs and profit margins. – The decline in inflation in the euro area reflected the further rise in the nominal effective exchange rate of the euro during the course of 2003, which over the first ten months averaged 12 per cent higher than in the year-earlier period. In the first six months the area-wide average implicit price deflator for imported goods and services continued to fall compared with the year-earlier period but less than with respect to 2002 as a whole (–0.8 and –1.6 per cent respectively). A similar pattern was observed in the main countries of the area (Figure 26).

Reuters' monthly survey of manufacturing purchasing managers points to a decline in input costs in the euro area since the spring (Figure 27). International dollar prices of non-energy raw materials remained virtually stationary; the euro appreciated by an average of 20 per cent against the US currency in the first ten months of 2003 from a year earlier, mitigating the effect of the upturn in oil prices, which settled at $30 a barrel (Brent grade) in October.

Figure 27

Demand and input costs for manufacturers



Source: Monthly survey conducted by Reuters of a sample of manufacturing firms.
(1) Percentage balance between positive replies ("high", "increasing") and negative replies ("low", "decreasing") by firms on the level of total orders. – (2) Purchasing managers of firms in the sample are asked to give their assessment of the behaviour of prices paid for inputs in relation to the previous month. An index level above 50 indicates an increase in input costs, below 50 a decrease.

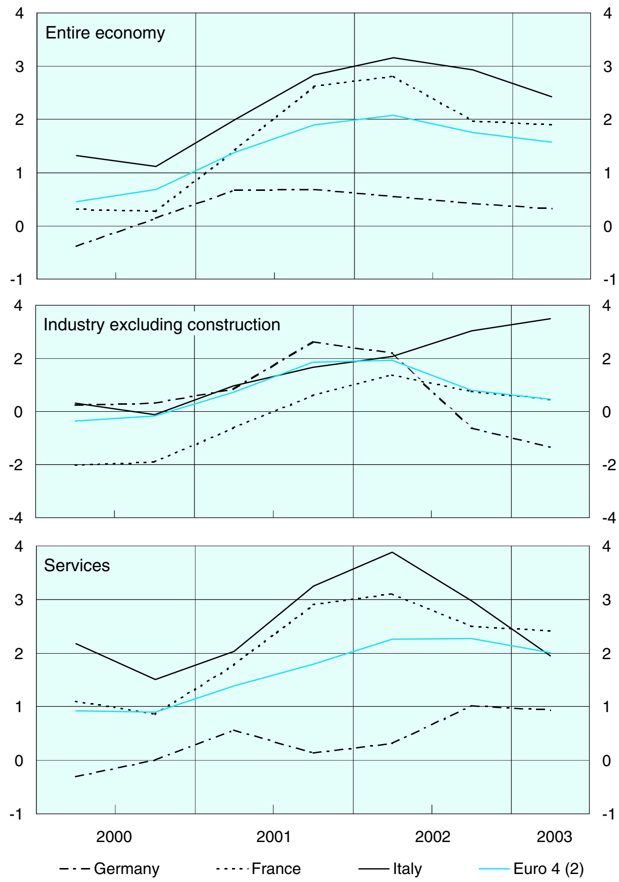
Continuing the trend under way since the second half of last year, inflationary pressures from internal costs in the euro area as a whole remained moderate in the first six months of 2003 (Figure 28). Unit labour costs in the economy as a whole increased on average by 1.7 per cent from the year-earlier period, reflecting a 2.3 per cent rise in nominal per capita earnings and limited gains in labour productivity (0.6 per cent). Again unit labour costs rose more sharply in the service sector than in industry excluding construction (2.1 and 0.7 per cent respectively), where labour productivity gains were much larger.

The performance of unit labour costs continues to diverge among the main euro-area countries: for the economy as a whole the increase was around 2.5 per cent in France and Italy, 3.5 per cent in Spain and 0.3 per cent in Germany. While the growth in earnings did not differ greatly among the various countries, in Germany labour productivity rose by almost 2 per cent but in Italy, at the opposite end of the scale, it declined slightly.

Figure 28

Unit labour costs (1)

(percentage changes on year-earlier half)



Source: Based on Eurostat data.
(1) To give a clearer picture of the trend, unit labour costs are calculated here, unlike in the text, on the basis of the moving average of the 2 half-years ending in the reference period. For Italy and Spain, unit labour costs are based on standard labour units. – (2) Average of the figures for France, Germany, Italy and Spain.

In the first half of 2003 unit labour costs in industry excluding construction performed very well in Germany and France at –1 per cent and +0.8 per cent respectively, since the cyclical weakness of demand was combined with a large drop in the number of employed workers (–3.2 and –2.4 per cent). In Italy, on the other hand, unit labour costs accelerated to 3.8 per cent from last year's already high rates as labour productivity again declined sharply. This caused a fall in the share of profits in value added, whereas in Germany the profit share rose.

In the service sector there was a decline, compared with the averages for 2002, in the growth rate of unit labour costs in Germany and Italy, which fell to 0.8 and 1.9 per cent respectively, while increasing slightly in France to 2.7 per cent. The share of profit in value added in the sector remained virtually unchanged in all three countries.

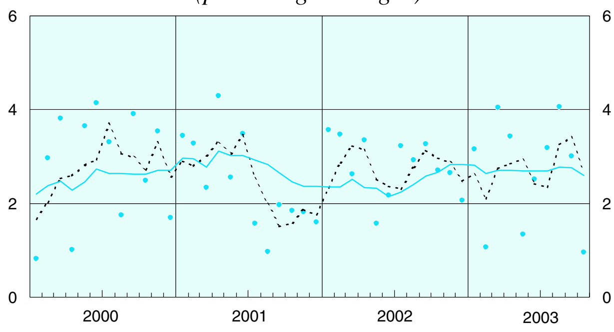
Prices and costs in Italy

During 2003 inflation in Italy, measured on the basis of the 12-month changes in the index of consumer prices for the population as a whole, held steady at its end-2002 level of just below 3 per cent (Figure 29). According to provisional data there was a slight decline in October, to 2.6 per cent.

Figure 29

Italy: general consumer price index

(percentage changes)



Source: Based on Istat data.
(1) Seasonally adjusted and annualized.

In the first nine months of 2003, while the general consumer price index rose by 2.7 per cent from the year-earlier period; among its components the prices of regulated goods and services, which had risen by only 0.7 per cent in 2002 and thus contributed significantly to abating inflationary pressures, surged by 2.2 per cent (Table 16). In particular, rises in the prices of tobacco products, up by 8.1 per cent, and in public service charges, notably for energy, up by 4.3 per cent after declining by 3.4 per cent in 2002, together accounted for approximately 0.5 percentage points of the rise in the general price index.

Among non-regulated items, the rise in prices of non-food and non-energy products edged down to 2 per cent in 2003. There was a similar reduction in the service sector although the rate of inflation remained high at around 3.6 per cent. Restaurant prices continued to rise sharply (up 4.6 per cent), as did insurance services (5.8 per cent) and bank commissions included in the consumer price index basket (9.1 per cent). The last two items contributed little to the average rate of inflation, however, as their weight in the basket is small. The prices of some durable goods declined, such as computers (–14.6 per cent), telephones (–1.3 per cent) and audio and video equipment (–1.1 per cent).

The prices of services continued to rise steadily in Italy while slowing in the other main euro-area countries, causing the inflation differential with the area as a whole to widen to 0.9 percentage points in the third quarter from an average of 0.3 points in 2002. The differential in the service sector more than doubled (0.7 percentage points in the third quarter), but this can be only partly ascribed to the protracted faster growth of domestic costs in Italy. Sectoral unit labour costs in Italy have been coming progressively into line with growth rates in the other main countries since the beginning of 2002, given similar developments in earnings and labour productivity (Figure 28). On the other hand, in the industrial goods segment the inflation gap, which showed practically no change from 2002, is still strongly affected by the poor performance of domestic costs compared with the area-wide average.

More detailed information on the costs of Italian firms is provided by the input and output price indicators used by Istat for the national accounts. In the first half of 2003 variable unit costs in manufacturing accelerated on average to 2.9 per cent, fueled by labour input (Table 17). As in 2002,

Table 16

Consumer prices in Italy (1)

	Percentage changes on year-earlier period		Percentage weights	Constributions to average inflation (percentage points)
	2002	2003 (2)	January 2003	2003 (2)
GENERAL INDEX	**2.5**	**2.7**	**100**	**–**
Unregulated goods and services	**2.9**	**2.8**	**82.0**	**2.3**
Unprocessed food products	5.3	3.6	6.9	0.3
of which: fruit	*8.9*	*5.4*	*1.0*	*0.1*
vegetables	*13.6*	*4.4*	*1.3*	*0.1*
Processed food products	2.4	2.3	9.8	0.2
Non-food and non-energy products	2.2	2.0	31.9	0.6
of which: footwear	*4.1*	*3.6*	*2.1*	*0.1*
computers	*-11.5*	*-14.6*	*0.2*	. .
telephones	*-2.8*	*-1.3*	*0.9*	. .
audio and video equipment	*-0.7*	*-1.1*	*0.4*	. .
Services	3.9	3.6	30.3	1.2
of which: medical services	*4.6*	*4.3*	*1.1*	*0.1*
repairs	*3.6*	*3.6*	*3.4*	*0.1*
restaurants and pizza parlours	*4.1*	*4.6*	*4.9*	*0.2*
hotels	*5.5*	*3.2*	*2.5*	*0.1*
other accommodation (3)	*3.3*	*18.0*	*0.3*	*0.1*
insurance	*11.6*	*5.8*	*0.4*	. .
banking (4)	*7.2*	*9.1*	*0.6*	*0.1*
Energy products	-1.9	3.2	3.1	0.1
Regulated goods and services	**0.7**	**2.2**	**17.9**	**0.4**
Medicines	-1.4	-4.1	2.9	-0.1
Tobacco	1.8	8.1	1.9	0.2
Rents	2.3	2.8	3.1	0.1
Public service charges	0.5	2.8	10.0	0.3
of which: energy	*-3.4*	*4.3*	*2.8*	*0.1*
post-office banking	*-0.5*	*26.7*	*0.2*	. .

Source: Based on Eurostat data.
(1) General price index for the population as a whole. – (2) Average for the first nine months of 2003. – (3) Includes camping, holiday tours, wagon-lits and couchettes. – (4) Includes commissions on current accounts, safe-deposit boxes, credit cards, safekeeping of securities and security and share trading.

they increased more than output prices, causing unit profit margins to contract further. In the service sector, however, margins widened owing to the acceleration in output prices and a decline in the growth rate of variable unit costs of both labour and other inputs.

Italian firms lowered their export prices only very slightly despite the slackening of demand. In the first seven months of the year average unit export values in euros on non-EU markets declined by around 0.8 per cent from the year-earlier period. Those on EU markets increased by 0.4 per cent,

Table 17

Unit variable costs and output deflator in Italy (1)

(percentage changes on year-earlier period)

	Manufacturing			Services (excluding public services)		
	Weights in 1995	2002	2003 H1	Weights in 1995	2002	2003 H1
Unit variable costs	**100.0**	**1.0**	**2.9**	**100.0**	**2.5**	**1.8**
Labour inputs	35.9	3.8	6.2	73.6	2.7	2.0
Other inputs	64.1	-0.5	1.0	26.4	2.2	1.4
Domestic	*38.3*	*0.9*	*1.8*	*19.9*	*3.1*	*0.7*
Imported	*25.8*	*-2.2*	*0.0*	*6.5*	*-0.4*	*3.4*
Output prices	**100.0**	**0.5**	**2.0**	**100.0**	**1.8**	**2.5**
Domestic	*58.3*	*3.0*	*1.0*	*91.3*	*1.8*	*2.4*
Imported	*41.7*	*-1.9*	*2.8*	*8.7*	*2.3*	*3.1*

Source: Istat.
(1) Indicators excluding intrasectoral transactions.

while the producer prices of goods sold in the EU internal market rose by around 2 per cent.

Inflation expectations

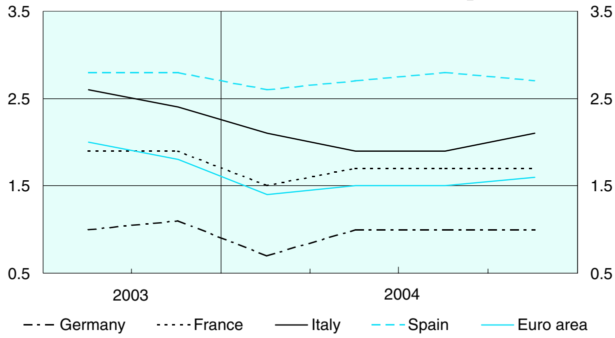
The professional forecasters surveyed monthly by *Consensus Forecasts* gradually raised their expectations for average inflation in 2003 in the euro area from 1.7 per cent in January to 2 per cent in October. The adjustment was larger for Italy, from 2.1 to 2.7 per cent. In October expected inflation for 2004 was 1.5 per cent for the euro area and 2.1 per cent for Italy; Italy's consumer price inflation differential vis-à-vis France and Germany is estimated at 0.5 and 1.1 percentage points respectively (Table 18), just slightly lower than average expectations for the current year.

The quarterly *Consensus Forecasts* survey of professional forecasters in September signaled expectations that Italy's rate of inflation would ease more gradually than had been expected at the beginning of the year. Consumer price inflation is not projected to drop below 2 per cent until the second quarter of 2004 (Figure 30).

Figure 30

Inflation expectations for the subsequent eight quarters

(percentage changes on year-earlier quarter)



Source: *Consensus Forecasts*, September 2003 survey of professional forecasters

According to the surveys of households conducted by the European Commission, consumer expectations in the euro area regarding price developments over the following twelve months have improved since the beginning of the second quarter of this year, reflecting the reversal of the trend in actual inflation. In Italy, the percentage of consumers projecting a slowdown in price increases rose from 16 per cent in January to 22 per cent in October, while the proportion of those expecting the inflation rate to remain virtually stable dropped by half to 14 per cent..

Table 18

Professional forecasters' inflation expectations for 2003 and 2004 in the euro area measured by *Consensus Forecasts*

	Forecasts 2003		Forecasts 2004	
	January 2003 survey	October 2003 survey	January 2003 survey	October 2003 survey
Italy	2.1	2.7	2.0	2.1
France	1.7	2.0	1.6	1.6
Germany	1.2	1.0	1.4	1.0
Spain	3.1	3.1	2.7	2.7
Euro area	1.7	2.0	1.7	1.5

According to the quarterly survey of a sample of about 520 Italian firms conducted jointly by the Bank of Italy and *Il Sole 24 Ore* in September, the respondents expected to raise prices by 1.5 per cent over the next twelve months, in line with the intentions expressed in earlier surveys. This increase is more than 1 percentage point lower than the rate of consumer price inflation that they project for Italy over the same period (2.8 per cent).

Indicators of longer-term inflation expectations, which can be gleaned from the market prices of financial instruments, indicate that inflation in the euro area will remain below 2 per cent.

THE PUBLIC FINANCES IN THE EURO AREA AND ITALY

The overall picture

According to the forecasts recently released by the European Commission, general government net borrowing in the euro area in 2003 will be equal to 2.8 per cent of GDP, compared with the 2.2 per cent recorded in 2002 and the 1.8 per cent given by the targets set in the euro-area countries' stability programme updates. The worsening of the balance mainly reflects the cyclical weakness of the economy. The ratio of debt to GDP is estimated to rise, after following a downward trend since 1997. The deficits of France and Germany are both expected to be more than 4 per cent of GDP; for both countries the excessive deficit procedure has been initiated.

In Italy the Government has repeatedly revised its evaluation of the public finances in 2003, as a consequence of the worse-than-expected outturn for 2002 and, above all, of the reduction in the estimate of economic growth (from 2.3 per cent in the autumn of 2002 to 0.5 per cent).

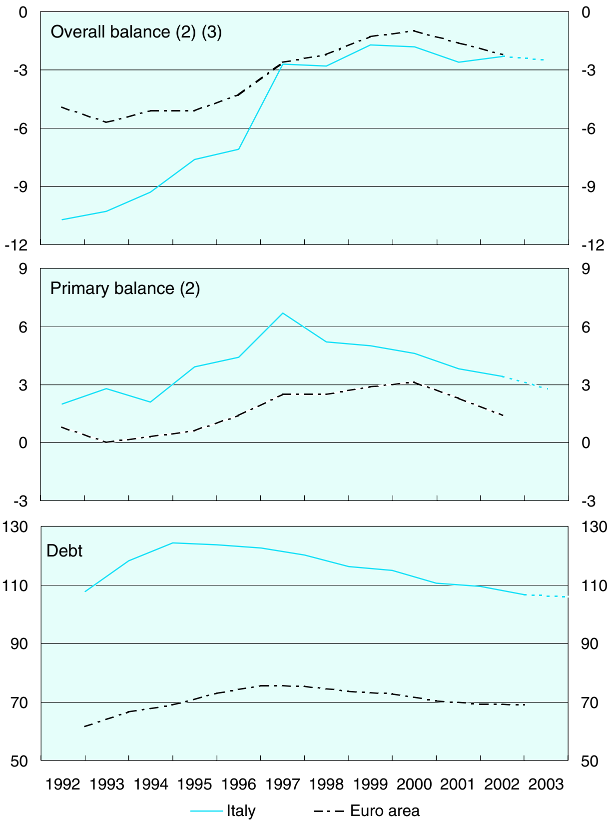
In September 2002 the Government set targets for 2003 of 1.5 per cent of GDP for net borrowing, 4.5 per cent of GDP for the primary surplus and 4.4 percentage points for the fall in the ratio of debt to GDP. In September 2003 the corresponding figures were 2.5 per cent for net borrowing, 2.8 per cent for the primary surplus and 0.7 percentage points for the reduction in the debt ratio (Figure 31).

Primary current expenditure is expected to increase by 4.4 per cent, compared with the year-earlier forecast of 2.9 per cent, implying a rise of 0.3 percentage points in relation to GDP to 38.5 per cent (Figure 32).

Taxes and social security contributions are expected to rise to 42.2 per cent of GDP, an increase of 0.6 percentage points. The stability programme update of November 2002 had indicated a fall of 0.4 points. The growth in revenue has benefited from the yield of the various tax regularization schemes, which was higher than expected.

Figure 31

Italy and the euro area: general government overall balance, primary balance and debt (1)
(as a percentage of GDP)



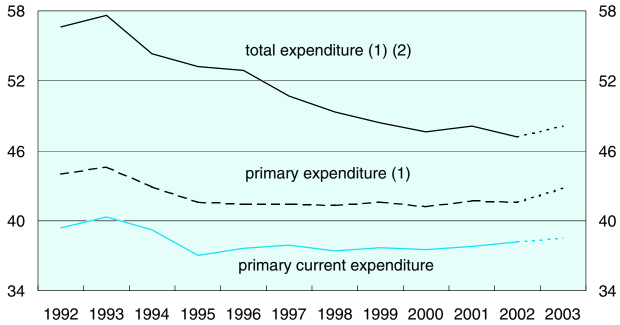
Sources: Based on Istat, Eurostat and EU Commission data; for Italy's debt, Bank of Italy. For 2003, the Update of the Economic and Financial Planning Document for the years 2004-07.

(1) Forecasts for 2003. Following the switch to ESA95, there is a break in the euro-area series of the balances between 1994 and 1995 and in that of the debt between 1995 and 1996. – (2) Excludes the proceeds of sales of UMTS licences. – (3) Includes the effects of swaps and future rate agreements.

The stagnation of economic activity continues to have an adverse effect on the public finances. The growth in the general government deficit has been curbed by the further fall in interest payments and the recourse to one-off measures, which are estimated to amount to around 1.5 per cent of GDP for the year as a whole.

Figure 32

Italy: general government expenditure
(as a percentage of GDP)



Sources: Based on Istat data. For 2003, forecasts from the Update of the Economic and Financial Planning Document for the years 2004-07.
(1) Excludes the proceeds of sales of UMTS licences. – (2) Includes the effects of swaps and future rate agreements.

In the first ten months of the year the state sector borrowing requirement, net of settlements of past debts and privatization receipts, was €54.8 billion, an increase of €5.5 billion compared with the year-earlier period.

For the year as a whole the Government estimates that the state sector borrowing requirement will be €45 billion, or 3.5 per cent of GDP; reaching the target for net borrowing indicated in September (2.5 per cent of GDP) would imply a widening of the gap between the two aggregates compared with the two years 2001-02.

To ensure that the planned reduction of 0.7 percentage points of GDP in the debt ratio is achieved, the Government is implementing measures of a financial nature.

Objectives and forecasts for the euro area

On the basis of the stability programme updates submitted between November 2002 and June 2003, general government net borrowing for the euro area was set to fall from 2.2 per cent of GDP in 2002 to 1.8 per cent this year, with a position close to balance being reached in 2006 (Table 19). The targets were less ambitious than those set in the year-earlier updates, which indicated budgetary balance being reached in the euro-area in 2004; the revision took account of the unfavourable economic conditions.

In most of the euro-area countries the targets for the budget in 2003 are likely to be missed. This appears to be mainly due to the further worsening of the economic environment. According to European Commission estimates published in October, euro-area GDP growth will be 0.4 per cent, instead of 2.1 per cent as given by the stability programme updates.

In November 2002 the Commission had indicated a reduction of 0.2 percentage points of GDP in euro-area net borrowing in 2003. In the spring of this year it estimated the aggregate would increase to 2.5 per cent of GDP, compared with 2.2 per cent in 2002.

The forecasts published in October gave a deficit of 2.8 per cent of GDP for 2003 and 2.7 per cent for 2004. They showed a deterioration for all the euro-area countries except Belgium in 2003. Among the countries with deficits of more than 2 per cent of GDP in 2002, net borrowing was set to increase significantly in France (by 1.1 percentage points to 4.2 per cent of GDP) and Germany (by 0.7 points to 4.2 per cent) and to a lesser extent in Italy (by 0.3 points to 2.6 per cent) and Portugal (by 0.2 points to 2.9 per cent). Among the other countries, the budgetary position was set to deteriorate significantly in Finland (by 1.8 percentage points of GDP), Luxembourg (by 3 points) and the Netherlands (by 1 point).

The Commission expects the area's ratio of debt to GDP to rise from 69 per cent in 2002 to 70.4 per cent in 2003 and 70.7 per cent in 2004. The rise in 2003 is seen as primarily due to the increases foreseen in France (3.6 percentage points, to 62.6 per cent), Germany (3 points, to 63.8 per cent) and the Netherlands (2.2 points, to 54.6 per cent).

In January 2003, with account taken of the estimated outturn for 2002, the European Council deemed that Germany was in an excessive deficit situation and served an early warning on France. Germany received a recommendation to overcome the excessive deficit situation as soon as possible and to ensure that the adjustment of 1 percentage point

Table 19

Euro area and the EU: general goverment net borrowing and debt (1)
(as a percentage of GDP)

	2002		2003		2004	
	Euro area	EU	Euro area	EU	Euro area	EU
Net borrowing						
Stability and convergence programmes	2.2	2.0	1.8	1.7	1.1	1.1
European Commission (April 2003)	2.2	1.9	2.5	2.3	2.4	2.2
OECD (June 2003)	2.3	2.0	2.5	2.3	2.4	2.2
Outturn according to Eurostat (September 2003)	2.2	1.9	–	–	–	–
IMF (September 2003)	2.3	1.9	3.0	2.6	2.8	2.5
European Commission (October 2003)	2.2	1.9	2.8	2.7	2.7	2.6
Cyclically-adjusted net borrowing (2)						
OECD (June 2003)	1.9	1.6	1.6	1.4	1.6	1.5
IMF (September 2003)	2.0	1.7	1.7	1.6	1.4	1.3
Debt						
Stability and convergence programmes	69.7	63.0	68.7	62.3	67.0	60.8
European Commission (April 2003)	69.2	62.7	69.9	63.5	69.6	63.2
Outturn according to Eurostat (September 2003)	69.0	62.3	–	–	–	–
European Commission (October 2003)	69.0	62.5	70.4	64.1	70.7	64.4

Sources: Updates to the stability and convergence programmes submitted between November 2002 and June 2003; European Commission, *Spring forecasts*, April 2003; OECD, *Economic Outlook*, June 2003; IMF, *World Economic Outlook*, September 2003; Eurostat, press communiqué, 15 September 2003; and European Commission, *Autumn forecasts*, October 2003.
(1) GDP-weighted averages. – (2) Excluding Luxembourg.

of GDP planned for 2003 was achieved in full. In June of this year the Council raised no objections regarding the adequacy of the action Germany had taken in the meantime.

At the beginning of June, in the light of the outturn for net borrowing in 2002, the Council established that France was also in an excessive deficit situation. It recommended that the French Government adopt corrective measures within four months that would terminate the excessive deficit situation by the end of 2004.

In October the Commission submitted two recommendations regarding France to the Council for it to examine and decide on. The Commission noted that France had not taken effective action in response to the June recommendation. It also proposed asking France to make a larger reduction in its deficit in 2004 than currently planned: a reduction of 1 percentage point of GDP in the cyclically-adjusted budget balance. The Commission proposed to accompany this request with an extension of one year, to 2005, of the deadline for overcoming the excessive deficit situation.

The excessive deficit procedure initiated at the end of 2002 in respect of Portugal for the outturn of that country's budget in 2001 is still under way.

Budgetary policy in Italy

The Economic and Financial Planning Document presented in July of last year set an objective for general government net borrowing of 0.8 per cent of GDP in 2003 (Table 20), a reduction of 0.3 percentage points compared with the result then expected for 2002. The objective for the primary surplus was set at 5.1 per cent of GDP. The debt ratio was expected to fall by 4 percentage points. The underlying projection for GDP growth in 2003 was 2.9 per cent.

In the September 2002 update of the Planning Document the target for net borrowing was raised by

0.7 percentage points to 1.5 per cent of GDP and that for the primary surplus was lowered to 4.5 per cent. The revision followed the worsening of the estimates of the deficit for the year (from 1.1 to 2.1 per cent of GDP) and the lowering of the economic growth forecast for 2003 to 2.3 per cent. The state sector net borrowing requirement in 2003 was expected to be 2.8 per cent of GDP.

In order to achieve the targets, the Government submitted a budget to Parliament intended to produce an adjustment of 1 per cent of GDP. The Finance Law was expected to bring a net increase in revenue of €4.3 billion and a net reduction in expenditure of €4.7 billion. Additional savings amounting to €3.3 billion were expected from measures not included in the Finance Law concerning public enterprises. A large part of the adjustment was entrusted to one-off measures; the increase in revenue was to come almost entirely from tax regularization schemes.

The planning scenario set out in the update of the Planning Document was confirmed in the stability programme update of November 2002.

In April 2003, in the Quarterly Report on the Borrowing Requirement and the update of the Forecasting and Planning Report, the Government raised the estimate of net borrowing to 2.3 per cent of GDP and lowered that of the primary surplus to 3.2 per cent. Account was taken of the lowering of the estimate of economic growth (from 2.3 to 1.1 per cent) and of the worse-than-expected budget outturn in 2002. The state sector and public sector borrowing requirements were forecast to amount to respectively 3.2 and 3.6 per cent of GDP. The debt ratio was seen as coming down by 0.8 percentage points.

In the Economic and Financial Planning Document for 2004-07 issued in July, the Government lowered the forecast for the primary surplus to 3 per

Table 20

Italy: public finance targets and estimates for 2003
(billions of euros and percentages)

	State sector net borrowing requirement (1)	General government				*Memorandum items:*	
		Net borrowing	Primary surplus	Interest payments	Debt	Real GDP growth rate	Nominal GDP
Targets							
Economic and Financial Planning Document (July 2002)	….	10.8	67.6	78.4	….	2.9	1,325.4
as a percentage of GDP	*….*	*0.8*	*5.1*	*5.9*	*104.5*		
Economic and Financial Planning Document Update (September 2002)	36.0	19.6	58.6	78.2	….	2.3	1,305.0
as a percentage of GDP	*2.8*	*1.5*	*4.5*	*6.0*	*105.0*		
Stability Programme Update (November 2002)	….	….	….	….	….	2.3	1,305.0
as a percentage of GDP	*….*	*1.5*	*4.5*	*6.0*	*105.0*		
Estimates made during the year							
Quarterly Report on the Borrowing Requirement and Forecasting and Planning Report Update (April 2003)	42.0 (2)	30.1	41.3	71.4	….	1.1	1,307.1
as a percentage of GDP	*3.2*	*2.3*	*3.2*	*5.5*	*105.9*		
Economic and Financial Planning Document (July 2003)	43.0	30.4	38.9	69.3	….	0.8	1,303.7
as a percentage of GDP	*3.3*	*2.3*	*3.0*	*5.3*	*105.6*		
Forecasting and Planning Report and Economic and Financial Planning Document Update (September 2003)	45.0	32.9	36.4	69.3	….	0.5	1,300.2
as a percentage of GDP	*3.5*	*2.5*	*2.8*	*5.3*	*106.0*		

(1) Net of settlements of past debts and privatization receipts. – (2) The Quarterly Report on the Borrowing Requirement indicated a net borrowing requirement of €46.5 billion.

cent of GDP in connection with the further reduction in the economic growth expected (from 1.1 to 0.8 per cent). Since the estimate of interest payments was revised downwards, the Quarterly Report on the Borrowing Requirement's forecast for net borrowing was confirmed (2.3 per cent of GDP).

In September 2003 the update of the Planning Document and the Forecasting and Planning Report increased the estimates of net borrowing and the net state sector borrowing requirement to respectively 2.5 and 3.5 per cent of GDP (in 2002 the results for the two aggregates were respectively 2.3 and 2.1 per cent). The estimate of economic growth was lowered to 0.5 per cent and that of the primary surplus to 2.8 per cent of GDP. The ratio to GDP of taxes and social security contributions is expected to rise by 0.6 percentage points to 42.2 per cent as a consequence of the receipts generated by the tax regularization schemes; that of primary current expenditure is expected to rise by 0.3 percentage points to 38.5 per cent. The cyclically-adjusted budget balance is forecast to decrease by 0.3 percentage points of GDP between 2002 and 2003, while the debt ratio is expected to fall by 0.7 percentage points to 106 per cent.

In 2003 substantial use has been made of one-off measures. Their contribution to curbing net borrowing can be estimated at about 1.5 per cent of GDP for the year as a whole, basically in line with the figure for 2002 and some three times that for 2001. Excluding the effects of these measures and those of the economic cycle, the structural primary surplus falls below 2 per cent of GDP, which is less than that needed to ensure a steady and sufficient reduction in the debt ratio.

There are also signs of a widening of the gap between the general government net borrowing requirement and general government net borrowing, after it had been held in check in 2002 by means of one-off financial measures.

The performance of the public finances during the year

In the first nine months of 2003 the Italian general government borrowing requirement, net of settlements of past debts and privatization receipts, was €42.9 billion, compared with €42.5 billion in the corresponding period of 2002 (Table 21).

Table 21

Italy: main public finance indicators (1)
(millions of euros)

	2000	2001	2002	2003
	General government net borrowing			
Whole year	21,359	32,229	29,059	32,900 (1)
as percentage of GDP	*1.8*	*2.6*	*2.3*	*2.5* (1)
	Net state sector borrowing requirement (2)			
Jan. - Oct.	30,511	37,980	49,318	54,800
Whole year	27,386	33,547	26,040	45,000 (1)
as percentage of GDP	*2.3*	*2.7*	*2.1*	*3.5* (1)
	Net general government borrowing requirement (2)			
Jan. - Sept.	28,367	29,578	42,510	42,925
Whole year	35,959	37,314	33,442	–
as percentage of GDP	*3.1*	*3.1*	*2.7*	–
	Gross general government borrowing requirement			
Jan. - Sept.	31,830	32,418	45,607	48,277
Whole year	25,110	43,275	37,341	–
as percentage of GDP	*2.2*	*3.5*	*3.0*	–
	General government debt			
At 30 September	1,309.114	1,333.623	1,389.184	1,409.997
At 31 December	1,290.459	1,336.038	1,342.926	–
as percentage of GDP	*110.6*	*109.5*	*106.7*	*106.0* (1)

Sources: For general government net borrowing, Istat; for the state sector borrowing requirement, Ministry for the Economy and Finance.
(1) Estimate contained in the Update of the Economic and Financial Planning Document for the years 2004-07. – (2) Net of settlements of past debts and privatization receipts.

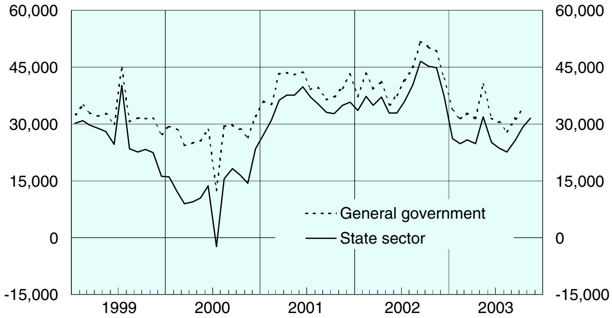
The state sector net borrowing requirement in the first ten months amounted to €54.8 billion, compared with €49.3 billion in the corresponding period of 2002.

Considering the receipts from the securitization of INPDAP claims at the beginning of November and those expected from the payment on account of self-assessed taxes and the second instalment of the amounts due in respect of tax regularization schemes, the last two months of the year should see a significant surplus. The state sector net borrowing requirement appears to be in line with the objective set by the Government (€45 billion).

The rolling twelve-month figure for the net borrowing requirement provides an indication of the performance of the public finances on a cash basis. Both for general government and for the state sector, the value of this aggregate, which in the second half of 2002 was held in check mainly by means of one-off measures, has been rising since August (Figure 33).

Figure 33

Italy: rolling twelve-month borrowing requirement (1)
(millions of euros)



(1) Net of settlements of past debts and privatization receipts.

In the first half of this year state sector expenditure increased by 1.4 per cent compared with the corresponding period of 2002; primary current expenditure increased by 3.7 per cent (see the box "State sector expenditure").

In the first nine months of 2003 tax revenue increased by 5.9 per cent on a cash basis; the figure refers to the aggregate that includes not only central government taxes but also the regional taxes collected by central government (see the box "Tax revenue"). The increase was produced by the receipts from the tax regularization schemes included in the budget for 2003, which more than offset the effects of the weakness of economic activity (although these were moderated by the rise in employment), the decline in interest rates and some tax measures adopted in earlier years.

The public debt in Italy

The reduction of the debt ratio to 106 per cent expected in 2003 implies, given the estimate of GDP growth published by the Government in September, an increase in the debt of about €35 billion.

In the first nine months of the year general government debt increased by €67.1 billion, against €53.1 billion in the corresponding period of 2002. The difference reflects the larger gross borrowing requirement and, above all, the larger volume of liabilities issued in connection with the increase in the balances on the Treasury's accounts with the Bank of Italy. The increase in the debt was curbed by issue discounts and the effect of the strengthening of the euro on the value of the liabilities denominated in foreign currencies (Table 22).

Table 22

Italy: change in general government debt and its components
(millions of euros)

	Jan. - Sept. 2002	Jan. - Sept. 2003
Change in debt	**53,146**	**67,072**
Gross general government borrowing requirement	45,607	48,277
Settlements of past debts	*3,274*	*5,353*
Privatization receipts	*178*	*1*
Financing of the change in the Treasury's deposits with the Bank of Italy	8,448	24,107
Issue discounts and premiums	902	-3,141
Euro equivalent of foreign currency liabilities	-1,810	-2,171

In the last three months of the year the debt should diminish. In October the increase deriving from the state sector net borrowing requirement (€10.8 billion) was more than offset by the reduction in the balances on the Treasury's accounts with the Bank of Italy (€18.3 billion), which nonetheless exceed the value at the end of 2002 by €5.8 billion. In addition a part of the Treasury's holding of Enel shares was sold for €2.2 billion. As mentioned earlier, in the last two months the state sector is expected to record a substantial surplus and the Treasury should also be paid the consideration for the privatization of Ente tabacchi italiani (about €2.3 billion).

Tax revenue

Tax receipts during the year can be analyzed in terms of three monthly data flows:[1] two refer to the state budget, of which one is on an accrual basis[2] and the other on a cash basis,[3] and the third refers to a broader aggregate and is on a cash basis.[4] The figures on an accrual basis are used to calculate net borrowing, while the others provide indications concerning the formation of the borrowing requirement.

In the first nine months of the year state budget tax revenue grew on an accrual basis by 5.9 per cent (2.7 per cent excluding receipts from regularization schemes); on a cash basis it grew by 3.3 per cent (0.5 per cent excluding receipts from regularization schemes).

Over the same period tax revenue on a cash basis for the larger aggregate grew by 5.9 per cent. The outcome was influenced by the increase of 6.6 per cent in Irap and that of 24.6 per cent in the regional personal income surtax, which benefited from the rate increases approved by the regions for 2002.

Analysis of state budget tax revenueon a cash basis

In the first ten months of the year state budget tax receipts rose by 3.5 per cent on a cash basis (see table). The receipts deriving from the various regularization schemes introduced in the budget for 2003 that had been allocated at 31 October amounted to €6.1 billion (with the regularization of direct and indirect taxes contributing respectively €4.1 billion and €2 billion); some of the payments made in the first ten months are still being held on accounts with the Treasury. Classified among non-tax budget revenue, the receipts deriving from the so-called tax shield (a measure permitting the repatriation or regularization of assets held abroad in violation of foreign exchange and tax laws) amounted to €0.6 billion.

The growth in direct taxes amounted to 2.9 per cent and was held back by the reduction in receipts of corporate income tax and the tax on interest income. The result for corporate income tax was affected by the fall of 12.2 per cent in the balance paid for 2002, which reflected not only the weakness of the economy but also the tax incentives for investments in earlier years. The payments on account, which were not affected by the investment incentives, increased by 2.8 per cent.

Receipts of personal income tax grew by 1.8 per cent. The self-assessed part, to which the investment incentives also applied, showed a similar pattern to that of corporate income tax. The part withheld from employee incomes grew less than total earnings owing to the start made on the planned reform of personal income tax (see the box "The first step of the reform of personal income tax", in Economic Bulletin*, No. 36, 2003).*

Receipts of the tax on interest income and capital gains fell by 19 per cent, partly owing to the decline in interest rates. All the main components contracted: the tax on income from bank deposits by €1.1 billion, that on income from bonds by €0.4 billion and that on the disposal of businesses by €0.1 billion.

The other direct taxes increased primarily as a consequence of the tax regularization schemes introduced in the budget for 2003. Another contribution came from the new tax on insurance companies introduced at the end of 2002, which brought in €0.6 billion.

Turning to indirect taxes, receipts of VAT rose by 3.4 per cent. The yield of other business taxes rose by 14.9 per cent. Net of the proceeds of regularization schemes, they fell by 4.7 per cent; the downturn was partly due to tax collection agencies recovering the payment on account they had made at the end of 2002 (with effect from last year this was raised from 20 to 32 per cent of the payments for the year).

The rise in the yield of excise duties on mineral oils (1.8 per cent) was held back by the payment at the end of 2002 of part of the amount due in January 2003. The yield of other excise duties and sales tax benefited significantly from the rise of €0.8 billion in the excise duty on methane, as a consequence of the increase in the balance for the previous year paid in March.

[1] The processing of tax receipts takes place in various stages: after they have been assessed, taxes are collected by the tax collection

cont. ➤

State budget tax revenue on a cash basis (1)
(millions of euros)

	January-October			
	2002	2003	% composition in 2003	% change on 2002
Direct taxes	**126,838**	**130,519**	**53.5**	**2.9**
Personal income tax	94,750	96,475	73.9	1.8
of which: withholdings from employee incomes	*75,258*	*76,598*		*1.8*
balance	*4,729*	*4,540*		*-4.0*
payments on account	*6,210*	*6,525*		*5.1*
Corporate income tax	16,169	15,486	11.9	-4.2
of which: balance	*6,764*	*5,942*		*-12.2*
payments on account	*9,202*	*9,457*		*2.8*
Tax on interest income and capital gains	11,721	9,497	7.3	-19.0
Other(2)	4,198	9,061	6.9	115.8
Indirect taxes	**108,830**	**113,317**	**46.5**	**4.1**
VAT(3)	70,023	72,399	63.9	3.4
Other business taxes	10,099	11,603	10.2	14.9
Excise duties on mineral oils	15,443	15,723	13.9	1.8
Other excise duties and sales taxes	4,747	5,641	5.0	18.8
Monopolies	6,364	6,476	5.7	1.8
Lotteries	2,154	1,475	1.3	-31.5
TOTAL TAX REVENUE	**235,668**	**243,836**	**100.0**	**3.5**

Sources: Based on Bank of Italy and Ministry for the Economy and Finance data.
(1) The figures for 2003 are provisional. – (2) Includes receipts of inheritance tax, which are recorded in the state budget under "Business taxes and duties". – (3) Includes the receipts accruing to the EU.

agents, paid to the Treasury and allocated to the various chapters of the state budget. As of 1998, with the introduction of the unified tax payment form and the single mandate procedure, the time when taxes are paid to the Treasury is not the same as the time they are allocated; in some cases amounts may be paid in one month and allocated in another.

[2] *The data on an accrual basis refer to the assessment stage. They are contained in* Bollettino delle entrate tributarie*, which is published by the Fiscal Policies Department of the Ministry for the Economy and Finance.*

[3] *The state budget data on a cash basis refer to the allocation stage and are traditionally published in* Conto riassuntivo del Tesoro*; for some months now they have also been published in* Bollettino delle entrate tributarie. *The same data, net of accounting transactions with the Sicily and Sardinia regions, are also published monthly by the Bank of Italy in* Supplementi al Bollettino Statistico. Indicatori monetari e finanziaria. Finanza pubblica. *For a more detailed definition, see the Notes to the statistical tables in the Appendix (Table a21).*

[4] *In addition to state budget tax revenue, these data include receipts of Irap, the regional personal income surtax and the tax revenue of the Sicily region. The figures refer to the time taxes are paid to the Treasury. The monthly figures for the budget are adjusted to take account of factors such as the balance held by the Treasury at the end of each month pending allocation. The data are prepared by the Ministry for the Economy and Finance, which makes them public in a monthly press release.*

State sector expenditure

In the first six months of the year state sector expenditure amounted to 183.6 billion, an increase of 1.4 per cent compared with the corresponding period in 2002 (see table). Interest payments increased by 1 per cent, while primary expenditure increased by 1.5 per cent and primary current expenditure by 3.7 per cent.

Wages and salaries grew by 12.1 per cent (4.1 billion). About half the growth was due to the increase in social contributions paid to the State Sector Employees' Social Security Institute, INPDAP (9.5 billion, compared with 7.5 billion in the first half of 2002). Another expansionary factor was the renewal of the labour contracts of ministry employees and the reparameterization of the careers of school personnel.

Spending on intermediate consumption rose by 16.9 per cent (1 billion). A contribution to the increase came from the Government having deferred some expenditure to 2003 in the latter part of 2002.

Current transfers remained virtually unchanged. Those to social security institutions decreased by 0.7 billion, in connection with the increase in the social contributions paid to INPDAP, those to enterprises (notably Ferrovie dello Stato S.p.A. and Poste Italiane S.p.A.) by 1.1 billion and those to municipalities and provinces by 0.8 billion. Current transfers to regions rose by 5.7 per cent (1.8 billion); the component serving to finance the health system rose by 2.4 per cent (0.7 billion).

Capital expenditure fell by 13.4 per cent (1.9 billion). Investment rose by 21.7 per cent (0.5 billion), with most of the increase in the defence sector. Transfer payments on capital account fell by 19.1 per cent (2.2 billion). Those to enterprises decreased by 1.2 billion, partly as a consequence of the restrictions the Government imposed on employment and investment incentives with effect from the summer of 2002. The transfer payments on capital account to general government entities decreased by 0.9 billion, primarily owing to the replacement of transfers to the National Road Agency, Anas, with contributions to its equity capital.

Gross acquisitions of financial assets fell by 6.8 per cent. The increase of 0.6 billion in equity investments in relation to Anas was accompanied by a fall of 0.3 billion in disbursements of loans and advances, primarily as a result of a decrease in lending by the Cassa Depositi e Prestiti to local authorities.

Expenditure items of the state sector
(millions of euros)

	First six months			
	2002	2003	% change on year-earlier period 2002	% change on year-earlier period 2003
Current payments	**158,572**	**163,629**	**-0.7**	**3.2**
Wages and salaries	34,135	38,257	2.4	12.1
Intermediate consumption	5,874	6,865	5.3	16.9
Current transfers to:	82,836	82,861	3.8	0.0
social security institutions	*27,331*	*26,657*	*14.4*	*-2.5*
regions	*31,410*	*33,185*	*-8.0*	*5.7*
municipalities and provinces	*6,808*	*5,996*	*-1.3*	*-11.9*
households	*2,220*	*3,111*	*4.5*	*40.1*
enterprises	*6,397*	*5,334*	*21.7*	*-16.6*
non-residents	*3,157*	*3,512*	*70.4*	*11.2*
others	*5,513*	*5,066*	*-1.6*	*-8.1*
Interest payments	30,331	30,647	-16.6	1.0
Other	5,396	4,999	15.9	-7.4
Capital expenditure	**14,271**	**12,355**	**26.7**	**-13.4**
of which: fixed investments	*2,242*	*2,728*	*33.1*	*21.7*
transfer payments	*11,455*	*9,268*	*23.3*	*-19.1*
Financial expenditure	**8,206**	**7,652**	**13.8**	**-6.8**
of which: equity investments	*2,000*	*2,620*	*-40.4*	*31.0*
loans and advances	*4,332*	*4,066*	*32.7*	*-6.1*
TOTAL EXPENDITURE	**181,049**	**183,636**	**1.6**	**1.4**
Total expenditure net of interest payments	**150,718**	**152,989**	**6.3**	**1.5**
Current expenditure net of interest payments	**128,241**	**132,982**	**4.0**	**3.7**

Source: *Relazione trimestrale di cassa*, 30 June 2003.

THE SINGLE MONETARY POLICY, FINANCIAL INTERMEDIARIES AND MARKETS IN THE EURO AREA AND ITALY

Interest rates and the exchange rate of the euro

On 5 June the ECB Governing Council lowered the Eurosystem's official rates by a further 0.5 percentage points, following the reduction of 0.25 points on 6 March. The minimum bid rate on main refinancing operations currently stands at 2 per cent (Figure 34).

The rate cuts were decided in a context of diminishing inflationary pressures in the area, stemming in part from the appreciation of the euro, and persistent weakness of economic activity.

The behaviour of short-term market rates reflected the Governing Council's decisions and expectations concerning the future stance of monetary policy. From the beginning of 2003 to mid-June, the three-month interbank rate fell by 0.7 percentage points to 2.1 per cent, subsequently remaining stable.

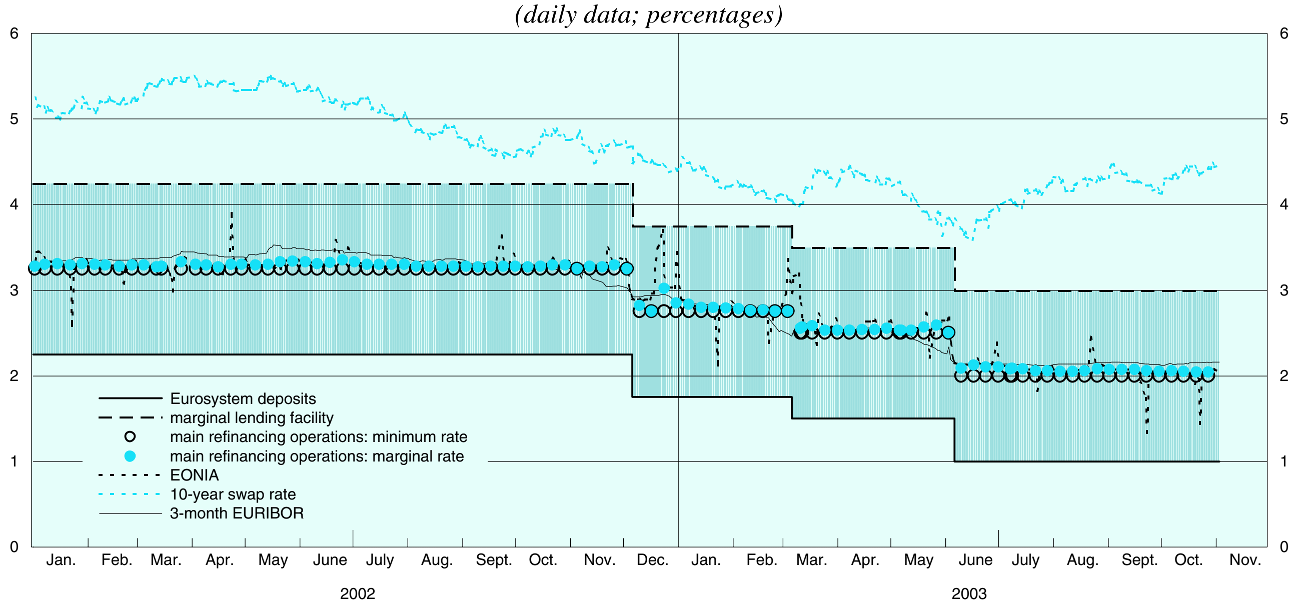
The yield curve shifted downwards during the first two quarters of 2003, owing to the stagnation of the economy. Over the summer it moved back up to the levels of the opening months of the year (Figure 35), in concomitance with the strengthening of signals of an international recovery coming especially from the United States and Japan.

The euro-area real short-term interest rate, calculated on the basis of surveys of expected inflation, fell to 0.3 per cent in September (Figure 36), the lowest level since the start of stage three of EMU. In Italy, where inflation is slightly higher than the area average, the real rate was negative in

Figure 34

Official interest rates and money and financial market rates in the euro area

(daily data; percentages)



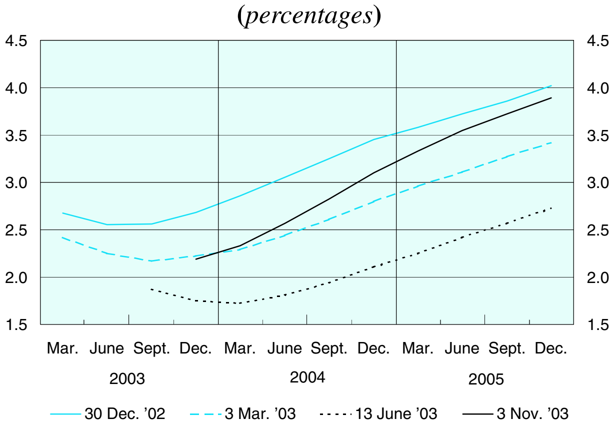
Sources: ECB, Reuters, Telerate.

June and September. In the United States the real rate rose slightly from the start of the year, but still remained negative. The markets expect real rates to rise gradually during 2004.

Figure 35

Rates on futures contracts on three-month Euromarket deposits (1)

(percentages)



Source: Reuters.

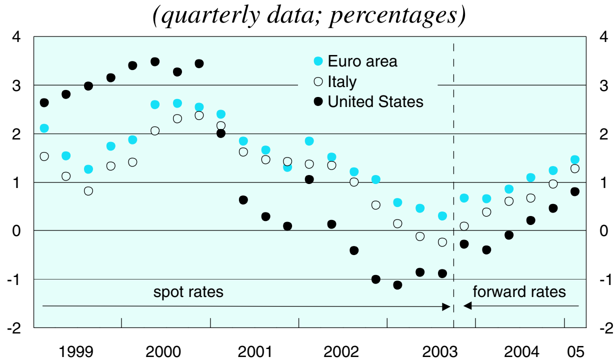
1) Each curve relates to the contract date indicated in the legend. The horizontal axis shows the settlement dates for the futures contracts to which the yields refer.

Long-term rates showed considerable fluctuations (Figure 34). The yield on ten-year government bonds, calculated as the weighted average of the yields on the benchmark securities of the main euro-area countries, was 4.4 per cent at the end of October, similar to its level at the start of the year and around 0.9 percentage points above the low reached in June.

Figure 36

Real spot and forward three-month interest rates (1)

(quarterly data; percentages)



Sources: Based on data from Reuters and *Consensus Forecasts*.

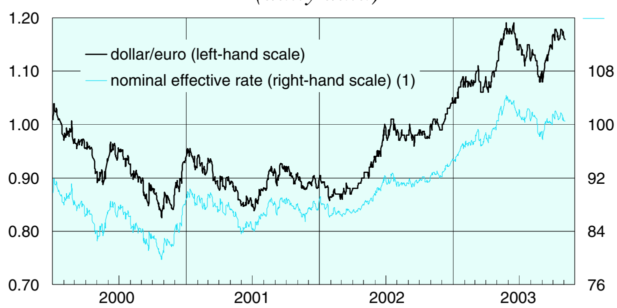
(1) Nominal three-month rates on Euromarket deposits (averages of daily data in the last month of the quarter), deflated using inflation expectations measured by the quarterly *Consensus Forecasts* survey of professional forecasters.

The euro appreciated sharply against the dollar and the other main currencies during the second quarter (Figure 37). Over the summer the release of positive data on economic developments in the United States and Japan coincided with a weakening of the euro. Subsequently there was renewed dollar depreciation. From the beginning of the year to the end of October the euro rose by 10.8 per cent against the dollar, by 5.5 per cent against sterling and by 1.9 per cent against the yen. In nominal effective terms the appreciation amounted to 6 per cent. In the first half of the year the strengthening of the euro was accompanied by a net direct and portfolio investment inflow into the area amounting to around €54 billion, compared with €17 billion in the first half of 2002.

Figure 37

Dollar/euro exchange rate and nominal effective exchange rate of the euro

(daily data)



Source: ECB.

(1) Index, first quarter of 1999=100.

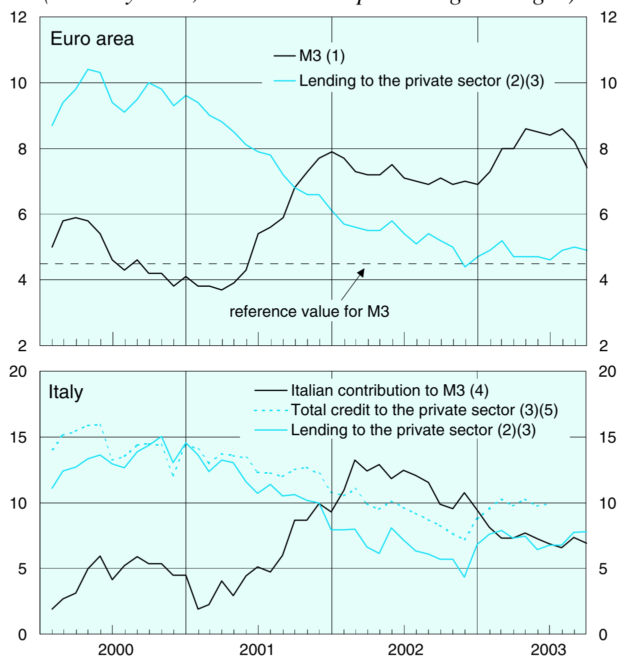
The money supply and credit

The twelve-month rate of growth in euro-area M3 rose steadily from the beginning of the year, reached a peak in April and then remained at high levels of more than 8 per cent until July (Figure 38). The expansion in current accounts and negotiable instruments was particularly fast. A substantial contribution to the growth in the money supply again came from the rebuilding of cash balances in euros. The growth in M3 began to slow down in August, declining to 7.4 per cent in September.

Figure 38

Monetary and credit aggregates

(monthly data; twelve-month percentage changes)



Sources: ECB and Bank of Italy.

(1) Changes are calculated on the basis of seasonally adjusted data corrected for calendar effects. – (2) Lending in euros and other currencies by monetary financial institutions (MFIs). – (3) The private sector includes households, non-financial enterprises, insurance companies, non-profit institutions serving households, non-money-market funds and other financial institutions. – (4) Excludes currency in circulation. – (5) Includes bonds and foreign loans in addition to lending by MFIs.

The rapid growth in M3, exceeding that in nominal income in the area, continued to reflect investors' preference for liquid assets in a setting of very low interest rates and persistent uncertainty about the economic outlook. In the past few months the deceleration in M3 has coincided with the marked reduction in stock market volatility.

There was a slowdown in the growth in the Italian component of M3, calculated net of currency in circulation, continuing a trend already under way in 2002; the deceleration was assisted from March onwards by the recovery in the stock markets. Nevertheless, the rate of growth remained high (6.9 per cent in the twelve months ending in September) and faster than that in nominal income.

The twelve-month growth in euro-area bank lending to the private sector rose moderately in 2003, reaching 5.5 per cent in September. This was the combined result of a very small increase in lending to non-financial firms (3.7 per cent in the third quarter) and rapid growth (above 7 per cent) in mortgage lending for house purchases, which was boosted by brisk activity in the property market.

In Italy the growth in credit to the private sector remained high (Table 23). Bank lending to residents increased by 7.8 per cent in the twelve months to September. The expansion in total credit, which also includes bonds and finance from abroad, was faster (9.9 per cent in the twelve months to June).

Households' financial saving and corporate financing in Italy

Against the background of weak growth in disposable income and an expansion in investment in housing, Italian households' financial saving – the difference between the change in financial assets and that in financial liabilities – was smaller in the first six months of 2003 than in the same period of 2002 (Table 24). Households began to invest again in investment funds while reducing their net purchases of medium and long-term debt securities. Net disposals of external assets amounted to €1.5 billion, less than those of the year-earlier period, which had mainly involved deposits and had been affected by the introduction of the measure facilitating the repatriation of capital. Valued at market prices, the total stock of households' financial assets was basically unchanged in June 2003 from a year earlier, as positive net portfolio investment was offset by the fall in the stock markets, which lasted until March.

Italian households continued to increase their medium and long-term borrowing. The stock of total household financial debt rose to 24.4 per cent of GDP (Figure 39), a historically high level but still considerably below the euro-area average (see the box "Bank lending to households in Italy").

According to national accounts data, the first half of 2003 saw a decrease in non-financial firms' operating profitability (gross operating profit over

Table 23

Credit and financial assets in Italy (1)

(end-of-period data)

	Total credit						Financial assets (4)					
		General govern-ment debt (2)	Total finance to the private sector (3)					Domestic				Foreign
				Bank lending	Domestic bonds	Finance from abroad			Monetary assets, other deposits and BOTs	Medium and long-term securities	Other financial assets (5)	
	Twelve-month percentage change											
2001 – Dec.	6.9	3.7	10.8	7.9	105.3	15.0	5.5	7.3	6.8	9.1	-15.9	1.8
2002 – Jan.	7.0	4.0	10.5	7.9	102.7	13.5	5.4	8.0	7.1	10.3	-14.6	-0.1
Feb.	7.0	3.8	11.0	8.0	134.9	13.4	6.0	9.4	8.0	12.4	-15.0	-1.4
Mar.	6.7	4.1	9.9	6.6	110.5	15.4	6.1	9.8	8.3	12.8	-13.4	-2.0
Apr.	6.3	3.7	9.5	6.1	109.6	15.0	5.2	9.8	8.0	13.0	-13.1	-4.5
May	6.3	3.3	10.1	8.1	73.9	11.7	4.9	9.6	7.6	12.8	-11.9	-5.2
June	6.1	3.2	9.6	7.2	55.6	14.7	4.8	10.5	8.6	13.9	-11.4	-7.4
July	6.3	4.0	9.2	6.3	60.3	15.2	4.5	10.2	8.4	13.3	-10.5	-7.9
Aug.	6.2	4.2	8.7	6.1	74.4	11.8	5.4	10.4	8.0	14.2	-8.6	-5.9
Sept.	6.1	4.3	8.3	5.7	67.3	11.9	4.6	9.2	6.7	13.2	-20.1	-5.9
Oct.	5.8	4.2	7.7	5.7	53.9	9.8	4.1	8.8	5.8	13.4	-20.2	-6.7
Nov.	5.8	4.6	7.2	4.3	54.3	13.6	4.4	9.6	6.9	13.9	-20.1	-7.5
Dec.	5.5	2.6	8.7	6.8	36.2	12.1	3.0	8.4	6.0	12.2	-19.5	-9.3
2003 – Jan.	6.0	3.0	9.6	7.6	38.8	13.1	2.9	7.7	5.7	11.0	-20.8	-8.2
Feb.	6.4	3.1	10.3	7.9	33.3	16.5	3.1	7.0	6.1	9.1	-24.2	-6.1
Mar.	5.8	2.5	9.7	7.3	38.4	14.8	2.5	5.9	5.0	7.7	-24.1	-5.6
Apr.	6.3	2.9	10.3	7.4	46.9	15.8	2.9	5.6	5.6	6.3	-24.5	-3.6
May	6.3	3.3	9.7	6.4	47.9	17.0	3.1	4.6	4.6	5.3	-24.6	-0.6
June	6.2	2.9	9.9	6.8	48.5	16.5	3.5	3.4	4.0	3.5	-26.1	3.9
July	….	2.6	….	6.8	….	….	….	….	….	….	….	….
Aug.	….	3.0	….	7.7	….	….	….	….	….	….	….	….
Sept.	….	4.0	….	7.8	….	….	….	….	….	….	….	….
	Percentage shares of stocks											
2001 – Dec.	100.0	53.4	46.6	36.8	1.5	8.3	100.0	69.2	37.3	30.8	1.1	30.8
2002 – Dec.	100.0	51.5	48.5	37.6	1.9	9.0	100.0	73.8	39.6	33.4	0.8	26.2
2003 – June	100.0	51.2	48.8	37.1	2.1	9.5	100.0	73.2	40.2	32.3	0.7	26.8

(1) Rounding may cause discrepancies in totals. – (2) According to the EU definition. — (3) Italian residents other than central government and MFIs. Corresponds to the “Other residents” sector in the harmonized statistics of the ESCB. – (4) For the definition of the holding sector, see footnote 3. – (5) Includes firms’ surety deposits and shares held by non-money-market funds.

value added); according to the Bank of Italy’s sample survey, the percentage of profitable firms remained stable at last year’s low level in 2003. The stagnation of production appears to have continued to limit the growth in self-financing, whose amount was virtually unchanged in 2002.

Italian firms’ gross financial liabilities rose from 59 per cent of GDP in June 2002 to 61 per cent in June of this year (Figure 40). The ratio is lower than the average for the firms of the major euro-area countries. Firms’ leverage, defined as the ratio of debt to the sum of debt and equity, remained

Table 24

Financial assets and liabilities of Italian households and enterprises (1)

(millions of euros)

	Households (2)			Non-financial enterprises		
	Flows		Stocks	Flows		Stocks
	Jan. - June 2002	Jan. - June 2003	June 2003	Jan. - June. 2002	Jan. - June. 2003	June 2003
Assets						
Cash and sight deposits	-6,645	7,032	440,743	-322	3,999	115,758
Other deposits	-2,469	-7,544	280,392	1,187	-326	8,556
Short-term securities	6,581	-7,315	8,068	-905	-607	81
Medium and long-term securities	47,836	2,938	517,845	-338	-5,553	31,397
of which: government securities	*25,976*	*-11,142*	*197,141*	*3,245*	*-3,716*	*15,266*
Investment fund units	-2,339	16,521	326,272	-33	230	4,538
Shares and other equity	-1,814	3,360	360,560	16,584	22,296	749,550
External assets	-11,929	-1,530	186,623	7,730	16,642	265,262
of which: deposits	*-20,449*	*-5,600*	*4,885*	*-1,621*	*-1,417*	*3,067*
short-term securities	*-272*	*-74*	*48*	*-41*	*-206*	*1,625*
medium and long-term securities	*7,396*	*3,312*	*91,834*	*271*	*475*	*19,204*
shares and other equity	*1,914*	*-640*	*64,727*	*6,431*	*3,645*	*112,856*
investment fund units	*-518*	*1,472*	*25,128*	*8*	*46*	*8,904*
Other financial assets (3)	13,800	19,627	416,327	18,810	-12,793	242,502
Total assets	**43,021**	**33,089**	**2,536,830**	**42,713**	**23,888**	**1,417,644**
Liabilities						
Short-term debt (4)	-651	-1,157	53,589	-3,978	468	316,306
of which: bank	*-675*	*-1,182*	*52,858*	*-4,930*	*-551*	*286,419*
Medium and long-term debt (5)	15,211	13,291	262,016	20,087	22,212	345,181
of which: bank	*14,737*	*12,785*	*240,098*	*14,894*	*17,943*	*269,682*
Securities	-	-	-	4,414	3,821	22,452
of which: medium and long-term securities	-	-	-	*4,236*	*2,865*	*17,621*
Shares and other equity	-	-	-	16,343	22,937	1,043,769
External liabilities	-	-	-	-794	-412	258,633
of which: short-term debt	-	-	-	*-2,291*	*-588*	*72,646*
medium and long-term debt	-	-	-	*352*	*0*	*5,996*
medium and long-term securities	-	-	-	*1,793*	*11*	*22,500*
shares and other equity	-	-	-	*920*	*-4,089*	*119,136*
Other financial liabilities (6)	932	1,013	26,794	21,801	-9,802	315,409
Total liabilities	**15,492**	**13,147**	**342,399**	**57,873**	**39,224**	**2,301,750**
Balance	**27,529**	**19,942**	**2,194,431**	**-15,160**	**-15,336**	**-884,106**

Source: Financial accounts.

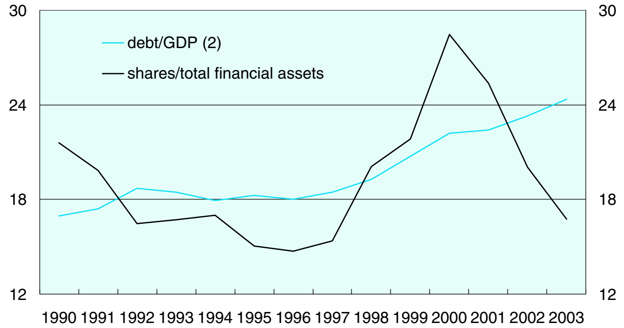
(1) Rounding may cause discrepancies in totals. – (2) Comprises consumer households, sole proprietorships with up to 5 employees and non-profit institutions serving households. – (3) Includes insurance reserves of the life and casualty sectors and domestic trade credit; for households, also includes pension funds. – (4) Includes finance provided by factoring companies and repos. – (5) Includes finance provided by leasing companies; for households, also includes consumer credit from finance companies. – (6) Includes severance pay and pension funds; for enterprises, also includes domestic trade credit and domestic derivatives.

stable by comparison with a year earlier; it is below the average for the last ten years. Thanks to the reduction in market interest rates the increase in debt had limited effects on firms' net interest expense, which came to 5 per cent of value added in the first half of 2003, against 5.2 per cent a year earlier.

Figure 39

Italian households' debt and shareholdings (1)

(percentages)



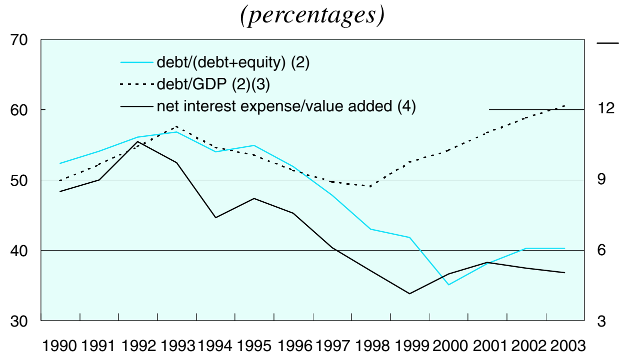
Sources: Financial accounts and Istat.

(1) From 1995 onwards the data refer to the new definitions of instruments and sectors of economic activity introduced by ESA95. The stocks refer to June of each year. Shares include other equity. – (2) GDP for the full year (estimated for 2003).

Figure 40

Debt and net interest expense of Italian non-financial enterprises (1)

(percentages)



Sources: Financial accounts and Istat.

(1) From 1995 onwards the data refer to the new definitions of instruments and sectors of economic activity introduced by ESA95. – (2) Left-hand scale. The stocks of debt and equity refer to June of each year. – (3) GDP for the full year (estimated for 2003). – (4) Right-hand scale. Net interest expense and value added refer to the full year, except for the figure for 2003, which refers to the first half and is estimated.

Firms' net purchases of shares and other equity exceeded those of the first half of 2002, in conjunction with an increase in the number of mergers and acquisitions. Overall, there were 73 such transactions involving Italian firms in the first half of this year, compared with 63 in the same period of 2002. By contrast, there was a decline in M&A activity in the other euro-area countries and the United States.

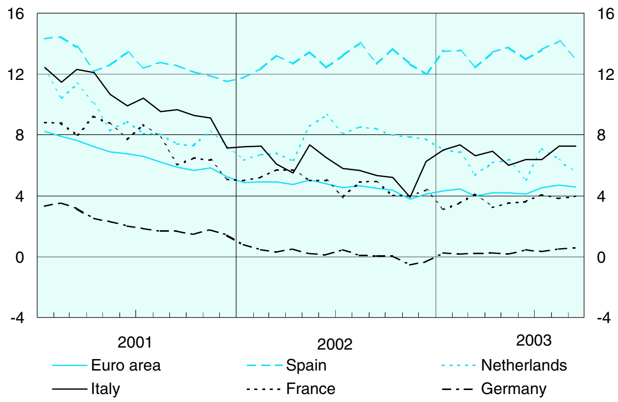
Bank lending in Italy

In the first nine months of the year bank lending accelerated slightly both in Italy and in the euro area, the rate of growth remaining higher in Italy (Figure 41).

Figure 41

Lending by monetary financial institutions in the euro area (1)

(monthly data; twelve-month percentage changes)



Sources: Based on ECB data and national statistics.

(1) Lending by monetary financial institutions (MFIs) of the euro area (excluding the Eurosystem) to non-MFI resident customers. The percentage changes are calculated net of reclassifications, exchange rate variations, value adjustments and other variations not due to transactions.

Lending by Italian banks to residents rose by 7.7 per cent in the twelve months ending in September (Table 25). The growth was concentrated in the component with a maturity of more than 18 months (13.9 per cent), while short-term lending continued to stagnate (Table 26). The lengthening of the maturities of bank credit involved firms of every size and all the productive sectors (Table 27). The proportion of medium and long-term credit rose by around 3 percentage points from the beginning of the year both for small firms, which are structurally more indebted, and for medium-sized and large ones. At the end of September loans beyond the short term accounted for 58 per cent of

Table 25

Bank funding and lending in the euro area and Italy (1)
(harmonized definitions; twelve-month percentage changes)

	Deposits					Debt securities issued (2)	Lending
		Excluding central government					
		Overnight	With agreed maturity	Redeemable at notice	Repurchase agreements		
				Euro area (3)			
2002 - Mar.	6.1	12.3	1.4	7.5	3.2	7.0	4.9
June	5.7	11.2	1.7	6.8	3.3	7.3	4.8
Sept.	5.1	9.3	1.5	6.6	5.5	6.6	4.5
Dec.	3.8	5.3	1.7	5.2	4.4	5.5	4.1
2003 - Mar.	5.2	8.1	1.7	7.0	1.8	5.3	4.0
June	5.9	8.4	1.5	8.7	-2.0	5.1	4.1
Sept.	5.5	8.9	1.1	8.8	-6.7	5.9	4.6
				Italy (4)			
2002 - Mar.	9.0	12.6	-8.0	5.0	8.3	10.3	6.1
June	8.3	11.9	-9.3	6.7	5.4	12.3	6.5
Sept.	7.1	9.0	-5.2	6.8	6.2	10.9	5.3
Dec.	6.7	7.2	-8.6	5.4	17.2	10.3	6.3
2003 - Mar.	4.3	7.0	-11.3	6.0	-2.2	8.7	6.8
June	4.8	8.3	-7.3	5.3	-9.2	6.4	6.8
Sept.	4.5	8.3	-9.0	6.0	-10.2	6.1	7.7

(1) End-of-period data. The data for September 2003 are provisional. The percentage changes are calculated net of reclassifications, exchange rate variations, value adjustments and other variations not due to transactions. The data are consistent with those published in the Monthly Bulletin of the ECB. — (2) Total debt securities, including money-market securities, issued by banks. By convention they are entirely attributed to euro-area residents. — (3) Funding and lending of the monetary financial institutions (MFIs) of the euro-area countries (excluding the Eurosystem) from and to non-MFI customers resident in the area. — (4) Funding and lending of Italian banks from and to non-MFI customers resident in Italy.

total outstanding loans to sole proprietorships and firms with fewer than 20 employees and 47 per cent for larger firms. The proportion of medium and long-term loans carrying variable rates fell by 2 percentage points to 70 per cent.

Lending to manufacturing firms, which had contracted in 2002, expanded by 5 per cent in the twelve months ending in September (Table 28). The increase was larger, and with an acceleration, in lending to the service sector (10.8 per cent). In concomitance with the expansion in investment in construction, credit to the construction industry continued to grow at a rapid pace (10.7 per cent).

Lending to small firms grew by 8.7 per cent in the twelve months ending in September, compared with an increase of 7.6 per cent for other firms.

In the South, the growth in lending to non-financial corporations was slightly below the national average. Credit to manufacturing industry and the construction sector accelerated, while lending to firms in the service sector slowed down (Table 28). In the North and Centre there was growth in lending to all the productive sectors.

Small and medium-sized banks led the expansion in lending to firms. Between December 2002 and September 2003 their market share rose by 1.3 percentage points for loans to small firms and by 2 points for loans to larger companies (to 44.4 and 30 per cent respectively).

Lending to consumer households rose by 9.5 per cent over the twelve months ending in September. €30 billion were granted for the purchase of houses, compared with €25 billion in the same period of 2002.

Table 26

Assets and liabilities of Italian banks (1)
(end-of-period data; percentage changes in period; millions of euros)

	2001	2002	2003 (2) Q1	2003 (2) Q2	2003 (2) Q3	September 2003 12-month % change	September 2003 Stocks
Assets							
Securities	-11.7	-15.6	11.8	11.3	4.2	2.0	174,742
of which: government securities	*-16.4*	*-19.8*	*2.2*	*7.9*	*10.8*	*-1.3*	*111,393*
Loans	7.2	6.3	8.4	7.7	8.0	7.7	1,068,753
of which: (3) *short-term (a)*	*6.4*	*0.5*	*1.0*	*2.0*	*-4.1*	*0.3*	*446,602*
medium and long-term (b)	*9.0*	*11.7*	*14.1*	*11.2*	*20.3*	*13.9*	*563,098*
(a)+(b)	*7.7*	*6.1*	*7.8*	*6.9*	*8.6*	*7.4*	*1,009,700*
repos	*-18.3*	*-7.2*	*120.6*	*7.0*	*-58.0*	*-12.2*	*6,276*
bad debts (4)	*-12.7*	*1.9*	*5.6*	*11.2*	*4.0*	*5.7*	*48,787*
Memorandum item:							
net bad debts (5)	*-13.6*	*-0.4*	*-23.4*	*5.5*	*15.4*	*-0.2*	*20,896*
External assets	-8.2	20.0	3.1	-2.5	-6.2	4.9	210,588
Liabilities							
Domestic funding (6)	7.8	8.0	2.7	7.1	5.2	5.1	1,064,580
Deposits	6.4	6.7	0.9	6.5	6.1	4.5	680,646
of which: (7): *overnight*	*9.4*	*7.2*	*11.8*	*11.9*	*8.0*	*8.3*	*492,032*
with agreed maturity	*-11.7*	*-8.6*	*-18.4*	*1.0*	*-8.1*	*-9.0*	*46,205*
redeemable at notice	*0.1*	*5.4*	*16.5*	*2.0*	*5.0*	*6.0*	*63,488*
repos	*11.6*	*17.2*	*-45.1*	*-18.4*	*6.6*	*-10.2*	*70,775*
Bonds (6)	10.6	10.3	6.1	8.1	3.7	6.1	383,935
External liabilities	4.1	-4.1	44.5	1.5	-2.1	11.5	287,686

(1) The figures for September 2002 are provisional. The percentage changes are calculated net of reclassifications, exchange rate variations and other variations not due to transactions. – (2) Annualized; based on seasonally adjusted data where appropriate. – (3) Some minor items in the aggregate are not reported. – (4) The percentage changes are not adjusted for debt cancellations and assignments. – (5) Bad debts net of write-downs. – (6) Includes bonds held by non-residents; the aggregate also includes money-market debt securities. – (7) Excludes those of central government.

Loans marked down to bad debts in the twelve months to June amounted to 1 per cent of total loans outstanding, the same as in 2002 (Table 29). The ratio of new bad debts rose in the South, while it remained stable in the North and Centre. At the end of September the stock of bad debts was equal to 4.6 per cent of total lending. The stock of loans to customers in temporary difficulty grew by 6.9 per cent in the twelve months to June, accelerating in all parts of the country; the ratio of these substandard loans to total loans outstanding remained unchanged at 2.1 per cent.

Credit conditions remained generally easy in the first nine months of the year, although banks did show more prudence in granting loans to riskier borrowers. The percentage drawn on overdraft facilities held at around 42 per cent. The differential between the average short-term lending rate and the minimum lending rate widened slightly to 2.5 percentage points in September, from 2.4 points at the end of 2002.

The responses of the Italian intermediaries participating in the Eurosystem's quarterly survey

Table 27

Lending by Italian banks to firms according to maturity and geographical area (1)

(twelve-month percentage changes) (2)

	North		Centre		South		ITALY	
	Dec. 2002	Sept. 2003	Dec. 2002	Sept. 2003	Dec. 2002	Sept. 2003	Dec. 2002	Sept. 2003
Total firms								
short-term	-2.4	-0.3	1.0	-0.3	4.5	4.8	-1.1	0.2
medium and long-term	15.7	17.7	18.6	24.3	10.2	8.8	15.6	18.1
Total	**4.5**	**7.2**	**8.0**	**10.6**	**7.2**	**6.8**	**5.5**	**7.9**
Manufacturing industry								
short-term................................	-4.9	2.0	-7.9	-3.1	-2.3	0.9	-5.2	1.0
medium and long-term	9.0	11.7	12.6	12.3	4.3	4.2	9.1	10.9
Total	**-0.1**	**5.6**	**-1.1**	**2.4**	**0.4**	**2.3**	**-0.2**	**5.0**
Construction								
short-term	3.4	5.5	1.9	5.0	8.7	4.9	3.7	5.3
medium and long-term	16.2	10.8	14.8	26.0	8.2	12.1	14.4	15.2
Total	**9.6**	**8.2**	**8.7**	**16.7**	**8.4**	**9.0**	**9.4**	**10.7**
Services								
short-term	-8.9	3.5	11.2	-0.6	6.7	3.7	-3.2	2.5
medium and long-term	16.9	17.3	28.4	27.9	16.4	16.4	19.5	19.8
Total	**1.6**	**9.8**	**18.5**	**13.1**	**11.0**	**9.7**	**6.4**	**10.8**

(1) Loans exclude repos, bad debts and some minor items included in the aggregate reported in Table 25. The breakdown by geographical area is based on customer residence. – (2) Calculated net of reclassifications, exchange rate variations and other variations not due to transactions.

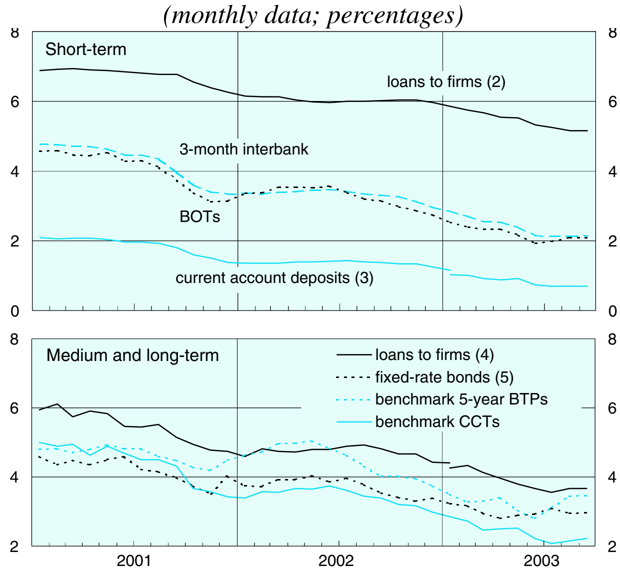
of credit conditions in the euro area confirm these indications. The banks reported that they had kept their standards for granting loans and opening credit lines virtually unchanged, although some indicated they had adopted a more cautious approach in lending to firms in specific branches of the economy owing to an increase in risk.

Bank lending rates fell, in line with developments in the rest of the area. On the basis of the statistics gathered and processed according to the new harmonized methodology of the Eurosystem (see the box “The new harmonized statistics on bank interest rates”), in Italy between January and September the average rate on the outstanding stock of short-term loans to firms fell by 0.7 percentage points to 5.2 per cent (Figure 42); that on overdrafts for households came down by 0.4 points to 8.7 per cent. The rate on new loan disbursements to firms declined by 0.6 points to 3.6 per cent; the decrease was larger (0.7 points) for smaller loans (less than €1 million). For households, the reduction in the annual percentage rate of charge was more pronounced for new loans for house purchase (from 5 to 4 per cent); for consumer credit, which accounts for around one tenth of total lending to households, the rate declined from 10.8 to 10.3 per cent.

Figure 42

Bank interest rates and rates on government securities in Italy (1)

(monthly data; percentages)



Sources: Based on Bank of Italy, MTS and MID data.

(1) Rates refer to operations in euros. – Since January 2003 data on bank interest rates are gathered and processed using the new harmonized methodology of the Eurosystem. – (2) Since January 2003, average rate on loans to firms with a maturity of up to one year. Before 2003, data were reconstructed using the monthly interpolation of three-month rates reported to the Central Credit Register for loans to firms with a maturity of up to 18 months. – (3) Up to December 2002, average rate on all customers' current account deposits. Since January 2003, average rate on current account deposits of households and firms. – (4) Up to December 2002, average rate on new loans with a maturity of more than 18 months to firms resident in Italy. Since January 2003, average rate on new disbursements with a rate fixed in advance for more than one year to firms resident in the euro area. – (5) Average rate on bank bonds issued during the month.

Table 28

Italian banks' lending by geographical area and economic sector (1)

	General goverment	Finance and insurance companies	Firms						Households		Total
				Holding companies	Non-financial corporations						
						Manu-facturing industry	Construc-tion	Services	Consumer households	Producer house-holds (2)	
	Twelve-month percentage changes (3)										
	Centre and North										
2002 - June	-5.0	9.2	6.1	13.0	5.6	0.4	10.9	8.3	10.0	6.4	6.5
Sept.	-2.5	-1.4	5.4	23.3	3.8	-0.7	10.1	6.5	10.1	6.3	4.9
Dec.	-4.3	5.6	5.3	22.9	3.9	-0.3	9.3	5.7	11.3	8.8	6.0
2003 - Mar.	-6.4	2.3	7.0	24.1	5.6	-0.2	9.2	8.0	11.6	8.4	6.5
June	-1.7	4.9	6.6	15.5	5.8	1.7	10.0	7.4	8.7	9.2	6.4
Sept.	-3.1	5.4	8.0	5.4	8.3	5.0	10.9	10.7	9.6	10.9	7.5
	South										
2002 - June	16.2	-8.9	5.2	-5.8	5.3	0.7	5.4	7.6	7.6	6.3	6.2
Sept.	12.8	-11.2	5.3	-31.4	5.5	0.3	5.6	8.6	8.0	5.3	6.0
Dec.	6.7	-14.3	7.2	1.2	7.2	0.4	8.4	11.0	8.8	7.0	7.0
2003 - Mar.	8.4	-19.5	8.5	-7.5	8.6	1.3	8.7	11.2	9.7	6.3	7.8
June	4.9	-20.3	7.0	21.9	7.0	1.3	9.4	10.2	8.4	6.6	6.5
Sept.	8.5	-16.6	6.8	0.0	6.8	2.3	9.0	9.7	9.2	7.8	7.2
	ITALY										
2002 - June	-2.8	8.5	6.1	12.8	5.6	1.2	9.4	8.7	9.5	6.4	6.4
Sept.	-0.9	-1.7	5.4	22.8	4.0	-0.6	9.4	6.7	9.6	6.1	5.0
Dec.	-3.2	4.9	5.5	22.7	4.2	-0.2	9.4	6.4	10.8	8.4	6.1
2003 - Mar.	-4.7	1.6	7.2	23.8	5.9	0.3	9.4	8.6	11.2	8.0	6.6
June	-0.9	4.0	6.6	15.5	5.9	2.0	10.1	8.0	8.6	8.6	6.5
Sept.	-1.8	4.7	7.9	5.4	8.1	5.0	10.7	10.8	9.5	10.2	7.5
	Stock of lending at September 2003 (4) *(millions of euros)*										
Centre and North	46,690	104,947	508,119	45,168	462,951	161,751	52,319	208,946	174,428	47,984	882,168
South	6,934	2,906	58,158	218	57,940	16,733	9,119	26,243	45,802	13,534	127,334
ITALY	53,624	107,853	566,277	45,386	520,891	178,488	61,442	235,197	220,231	61,517	1,009,502
	Percentage composition of lending at September 2003 (4)										
Centre and North	5.3	11.9	57.6	5.1	52.5	18.3	5.9	23.7	19.8	5.4	100.0
South	5.4	2.3	45.7	0.2	45.5	13.1	7.2	20.6	36.0	10.6	100.0
ITALY	5.3	10.7	56.1	4.5	51.6	17.7	6.1	23.3	21.8	6.1	100.0

(1) Loans exclude repos, bad debts and other minor items included in the aggregate reported in Table 25. The breakdown by geographical area is based on customer residence. – (2) Partnerships and sole proprietorships with up to 5 employees. – (3) Calculated net of reclassifications, exchange rate variations and other variations not due to transactions. – (4) The sum of stocks according to geographical area and sector of economic activity may differ from the total reported in Table 26, as the data are derived from different items of the supervisory reports.

Table 29

Italian banks' bad debts and substandard loans by geographical area and economic sector (1)

	General govern-ment	Finance and insurance companies	Enterprises						Households		Total
				Holding companies	Non-financial corporations				Consumer households	Producer house-holds(2)	
						Manu-facturing industry	Construc-tion	Services			
					Twelve-month percentage changes in bad debts (3)						
					December 2002						
Centre and North	8.2	-4.2	7.6	-7.7	8.0	4.9	10.9	8.9	17.3	2.7	8.8
South	12.7	-10.1	-7.0	108.1	-7.4	2.5	-20.9	-1.5	-7.4	-8.7	-7.5
ITALY	11.6	-5.6	2.4	1.2	2.5	4.2	-4.8	5.8	6.0	-3.6	1.9
					September 2003						
Centre and North	-5.0	2.4	9.0	58.9	8.2	10.1	3.8	9.1	0.9	10.5	7.3
South	-2.9	-15.5	3.4	25.4	3.2	13.3	2.4	-4.3	2.7	3.7	3.1
ITALY	-3.4	-1.7	7.2	51.9	6.6	11.0	3.3	4.8	1.7	7.0	5.7
					New bad debts during the year as a percentage of lending (4)						
					December 2002						
Centre and North	0.0	0.1	1.1	....	....	1.2	1.7	1.1	1.1	1.4	0.9
South	0.1	0.0	2.2	....	....	3.2	1.8	1.6	1.0	2.2	1.6
ITALY	0.0	0.1	1.2	....	....	1.4	1.7	1.2	1.1	1.6	1.0
					June 2003						
Centre and North	0.0	0.1	1.2	....	....	1.4	1.8	1.1	0.8	1.4	0.9
South	0.0	0.0	2.6	....	....	3.6	1.9	2.5	1.0	2.2	1.8
ITALY	0.0	0.1	1.4	....	....	1.6	1.8	1.2	0.8	1.6	1.0
					Twelve-month percentage changes in substandard loans						
					December 2002						
Centre and North	220.7	15.1	6.4	2.4	6.6	39.4	-23.3	3.9	-1.9	8.0	5.1
South	-43.0	27.8	-0.9	82.9	-1.0	-0.3	-20.5	22.4	13.9	3.7	2.8
ITALY	-24.5	15.6	5.0	2.8	5.1	29.8	-22.5	6.3	1.6	6.9	4.6
					June 2003						
Centre and North	242.2	18.2	7.5	-57.1	10.2	28.2	6.7	4.2	4.0	9.6	7.3
South	-20.9	-37.4	2.1	-19.0	2.2	4.9	-13.0	13.9	8.8	17.9	5.8
ITALY	11.7	13.7	6.5	-56.8	8.6	22.8	1.6	5.5	5.2	11.7	6.9

(1) The geographical distribution is based on customer residence. – (2) Partnerships and sole proprietorships with up to 5 employees. – (3) The percentage changes are not adjusted for debt cancellations and assignments. – (4) New adjusted bad debts as a percentage of the stocks of loans other than adjusted bad debts outstanding at the end of the preceding year. The data for holding companies and non-financial corporations are not available. The figures on new adjusted bad debts are taken from reports to the Central Credit Register.

Adjusting for regional differences in the composition of firms by size and sector, in the first six months of the year the difference between the rates on short-term bank loans to firms in the South and those in the Centre and North increased slightly, from 0.9 to 1.1 percentage points. By historical standards the disparity remains small.

Italian banks' fund-raising, securities holdings and profitability

Italian banks' domestic fund-raising showed a twelve-month increase of 5.1 per cent in September, the smallest since July 2001 (Table 26). The slowdown, which started at the end of 2002, is largely attributable to the contraction in bond issues, particularly those on the Euromarket. By contrast, there was an acceleration in current account deposits, due in part to the decrease in the opportunity cost of holding liquid balances following the fall in money-market yields.

Under the new harmonized statistical definitions, the average rate on households' and firms' deposits fell from 1.3 to 0.9 per cent between January and September; that on households' current accounts declined from 0.9 to 0.6 per cent.

Italian banks' exposure to interest rate risk remained unchanged, at moderate levels, in the first nine months of the year. Including current accounts and considering indexations, the difference between the average residual maturity of liabilities and assets stood at 5.8 months in September, as at the end of 2002.

In order to finance lending that outpaced funding, between the beginning of the year and the end of September banks increased their net external liabilities by €28.3 billion to €77.1 billion, or 3.8 per cent of total liabilities. The component subject to exchange rate risk shrank, with more than two thirds of net external liabilities denominated in euros, compared with around one half at the end of 2002.

In the first nine months of 2003 banks expanded their securities portfolios by 9 per cent, net of the change in securities prices. After reaching a low last December, the ratio of liquid assets (cash and securities) to the sum of loans and liquid assets rose by 0.4 percentage points to 15.9 per cent.

Banks' operating profit for the first half remained at the levels of the year-earlier period. The narrowing of the differential between lending and deposit rates was a factor reducing the growth in net interest income to 4.3 per cent, compared with 4.9 per cent in the first half of 2002. The performance of the financial markets had a positive impact on net income from securities and foreign exchange trading, which rose by 37.7 per cent. Income from services fell by 2.7 per cent. Overall, gross income grew by 2.5 per cent. Operating expenses increased by 3.6 per cent. Even though the number of employees diminished by 0.5 per cent, staff costs rose by 2.7 per cent, reflecting the impact of the wage increases provided for by the banking industry's collective labour contract.

The expenses connected with credit risk, calculated as the sum of net value adjustments and allocations to provisions, declined by 3 per cent from the high level recorded in the second half of 2002.

Calculated on an annual basis and including the operating results of Italian banks' foreign branches in net profits, the return on equity was 7.6 per cent, compared with 7.2 per cent in the first half of 2002 and 6.2 per cent in 2002 as a whole.

At the end of 2002 the Italian banking system's consolidated supervisory capital amounted to €134.4 billion (Table a39), 4 per cent more than a year earlier. The solvency ratio (supervisory capital as a percentage of risk-weighted assets) stood at 11.2 per cent, up from 10.4 per cent in December 2001.

The government securities market

Net issues of government securities in the euro area amounted to €173 billion in the first eight months of the year, compared with €166 billion in the same period of 2002. In Italy they increased substantially over the first nine months, from €53 billion to €63 billion (Table 30).

Table 30

Issues of Italian government securities (1)
(millions of euros)

	2002	2002 Jan.-Sept.	2003 Jan.-Sept.	2002	2002 Jan.-Sept.	2003 Jan.-Sept.
	Gross issues			**Net issues** (2)		
BOTs	208,761	169,606	173,693	-70	18,325	23,405
CTZs	32,556	29,956	29,535	8,335	14,746	1,624
CCTs	44,535	34,965	33,310	-12,290	2,055	-9,714
BTPs	133,646	100,415	119,572	42,364	12,032	40,317
Other	. .	. .	. .	-17,521	. .	-1,130
Total	**419,498**	**334,942**	**356,110**	**20,819**	**47,158**	**54,501**
Republic of Italy issues	16,135	15,641	18,456	4,388	6,002	8,474
Total government securities	**435,633**	**350,583**	**374,566**	**25,207**	**53,160**	**62,975**

(1) At face value. Rounding may cause discrepancies in totals. – (2) Net of issue differences; includes buy-backs and redemptions made by drawing on the sinking fund for the redemption of government securities.

In September the Treasury made its first issue of a five-year BTP indexed to euro-area consumer prices. Because of the large volume requested, the issue amount was raised from €2 billion to €7 billion and in October it was reopened for about €3 billion more. The security was purchased mainly by banks and investment funds, including a significant proportion of non-residents. The real yield at issue was 1.69 per cent before tax.

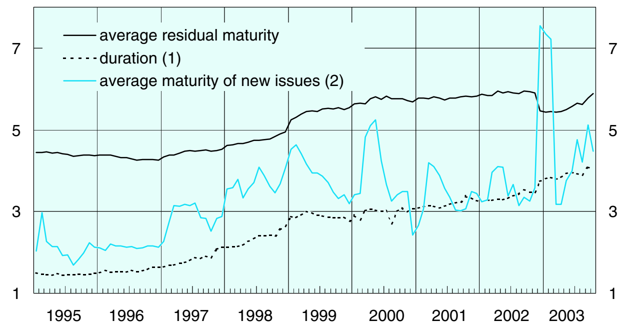
At the end of October the average residual maturity of the debt was equal to 5 years and 11 months and its average duration was 4 years, respectively 5 and 4 months longer than at the end of 2002 (Figure 43).

In the first six months of the year net purchases of Italian government securities were made primarily by investment funds and non-resident investors; in particular, the latter were the only net purchasers of BTPs (Table 31). Non-residents held 51 per cent of the stock of government securities outstanding at the end of June, compared with 46 per cent at the end of 2002.

The yield differential between ten-year BTPs and German Bunds narrowed further and was less than 15 basis points one third of the way through November.

Figure 43

Average maturity of outstanding Italian government securities and new issues
(monthly data; years)



(1) Calculated with reference to securities listed on MTS. — (2) Moving average for the three months ending in the month indicated.

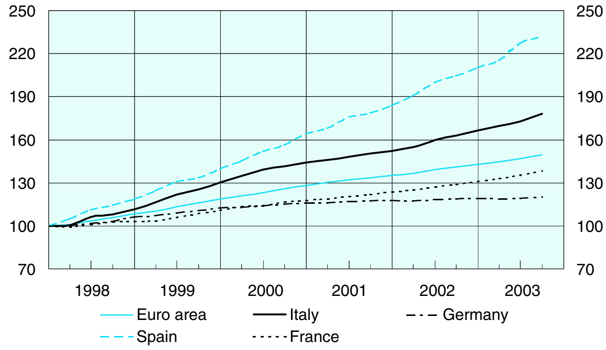
On the MTS Italian secondary market, in the first ten months of 2003 average daily turnover in spot trading fell by 2.5 per cent in comparison

Bank lending to households in Italy

In the five years between 1998 and 2002 bank lending to Italian consumer and producer households grew at an average annual rate of 10.7 per cent (see figure). This was higher than the 7.4 per cent growth registered by the euro area and, among the area's main countries, lower only than Spain (16 per cent). In 2003, although decelerating slightly, bank lending has continued to rise much faster in Italy than in the area as a whole.

Two thirds of the surge is attributable to the expansion in lending for house purchases against a background of lower real interest rates and the sharp rise in activity in the real-estate market, where the number of transactions increased by 17.6 per cent between 1998 and 2002. The growth in lending for home purchases was also fueled by fiercer competition among lenders, as is borne out by the extensive redistribution of market shares. A wide range of mortgage options were introduced to meet the requirements of different categories of customer. Lending in the form of consumer credit rose by an average 18.6 per cent a year between 1998 and 2002, almost twice the rate in the euro area.

Bank lending to households in the main euro-area countries
(quarterly data; indices, end-1997=100)



Sources: Based on ECB data and national statistics.

Table 1

Bank lending to households by use (1)
(end-of-period stocks as a percentage of GDP)

	Italy	*of which:* consumer households	France	Germany	Spain	Euro area
			1997			
Home purchases	5.2	4.8	20.3	37.3	21.2	23.9
Consumer credit	1.3	1.2	6.7	10.9	5.9	6.6
Other	9.7	4.9	5.6	14.9	7.2	9.5
Total	**16.2**	**12.1**	**32.5**	**63.1**	**34.2**	**39.9**
			2002			
Home purchases	10.0	9.3	22.7	43.7	34.8	30.8
Consumer credit	2.4	2.2	8.0	10.7	7.5	7.3
Other	9.5	5.2	4.3	12.3	8.9	8.3
Total	**21.9**	**16.7**	**35.0**	**66.7**	**51.2**	**46.4**

Sources: Based on ECB and Eurostat data and national statistics.
(1) Consumer and producer households (partnerships and sole proprietorships with fewer than 5 employees).

cont.

Although total lending to Italian households has increased substantially in recent years, at the end of 2002 it still only represented 21.9 per cent of GDP, compared with 16.2 per cent in 1997 (Table 1). This was a third of the ratio in Germany (66.7 per cent, compared with 63.1 per cent in 1997) and just over half that in France (35 per cent, up from 32.5 per cent).

In Italy lending to households for home purchases and consumer credit totaled 10 per cent and 2.4 per cent of GDP respectively, compared with 30.8 and 7.3 per cent in the euro area. By contrast, at 9.5 per cent of GDP the proportion of loans for other purposes was higher than the euro-area average of 8.3 per cent. About half of such loans are granted to producer households, which are more numerous in Italy.

Table 2

Italian households' debt (1)
(percentages)

	Percentage of debtor households	Total debt/total assets (2)(3)	Total debt/total financial assets (2)
Geographical area			
North	21.4	9.8	78.1
Centre	17.5	7.4	57.8
South and islands	13.4	10.0	112.5
Income (4)			
Up to 1st quintile (5) ...	5.6	7.3	32.1
Over 5th quintile (6) ...	30.8	8.6	68.2
Total	**18.0**	**9.3**	**78.0**

Source: Bank of Italy survey of households' income and wealth in 2002.
(1) Extrapolated to the universe. – (2) Only debtor households. Weighted averages. – (3) Financial assets, real-estate, business and valuables. – (4) Annual net disposable income (excluding income from financial assets). – (5) Up to €11,000. – (6) Over €33,000.

Italian households' low level of debt, together with a high propensity to save, is attributable to a number of factors. In the past, high real and nominal interest rates in Italy meant the overall cost of borrowing was high. At the beginning of 1995 the rate on long-term loans to households was over 13 per cent, or 8 per cent in real terms. Moreover, the growth in home loans has also been hampered by inefficient foreclosure procedures, which make recovery expensive in the event of default. Finally, only a small proportion of Italian households' purchases are made at major retail outlets, where the use of consumer credit is most frequent.

According to the Eurosystem's new harmonized interest-rate statistics (see the box The new harmonized statistics on bank interest rates*), at the end of September the average rate on outstanding loans to Italian households was 6.1 per cent. On new loans for home purchases the average rate applied to households was 3.9 per cent, compared with 4.9 per cent in Germany, one of the few countries for which comparable data are already available. The average rate on new consumer credit, net of incidental expenses, was 9.4 per cent in Italy, compared with 7.7 per cent in Germany. Including overdrafts, which are not part of consumer credit statistics although they are probably also used to finance goods purchases, the interest rate on lending to households falls to 8.7 per cent.*

The characteristics of borrowers can be analyzed using the Bank of Italy survey of household income and wealth. In 2000 only 18 per cent of Italian households had outstanding loans (Table 2), more of whom resided in the North (21 per cent) than the South (13 per cent).

About half of borrower households reported that they had taken out loans to buy or renovate property, while 62 per cent had borrowed to buy motor-vehicles or other durable goods. Only 4 per cent borrowed to pay for non-durable goods or services.

Borrowing is more frequent among households that are young, better educated and have larger incomes and wealth, implying greater financial stability. Among the wealthier households in the top fifth of the income distribution, 30.8 per cent had outstanding loans compared with 5.6 per cent in the lowest fifth. The total liabilities of debtor households amounted to 78 per cent of their financial assets and 9.3 per cent of total assets.

The new harmonized statistics on bank interest rates

Starting in December 2003 the ECB will release new harmonized monthly statistics on banks' interest rates for loans to households and non-financial corporations resident in the euro area. The Bank of Italy has already released the data available, for the first nine months of 2003, in its monthly "Supplements to the Statistical Bulletin - Monetary Financial Institutions: Banks and Money Market Funds".

The new statistics were instituted by Regulation (EC) No. 63/2002 (ECB/2001/18), the product of nearly two years of cooperative efforts on the part of the Eurosystem central banks. They will provide additional data for the conduct of monetary policy and the analysis of the stability of the financial system. The unharmonized statistics available until now suffered from heterogeneous national definitions and differing data collection methods.

The banks subject to the reporting requirement are those resident in the euro area. The other EU member states have been invited to supply data voluntarily. In order to speed up data collection and processing and reduce the number of banks involved, the national central banks may utilize a sample of banks, provided they comply with the prescribed requirements of representativeness and accuracy (see "L'armonizzazione delle statistiche europee sui tassi di interesse bancari e le scelte metodologiche italiane", Banca d'Italia, Supplementi al Bollettino Statistico: Note metodologiche e informazioni statistiche, No. 57, 29 October 2003).

The ECB Regulation calls for monthly observation of interest rates on 45 categories of deposits and loans, 14 referring to outstanding amounts and 31 to new business. New business comprises contracts signed during the month and those for which at least one of the terms has been renegotiated. The Bank of Italy publishes data on 35 of the interest rates to be observed plus 13 weighted average rates from aggregation of the categories. It does not release data on rates on 10 instruments offered by just a few banks or involving negligible amounts.

For most of the observed categories, interest rates exclude related charges. The annual percentage rate of charge (APRC), including such items as the cost of inquiries, administration, preparation of documents and credit insurance, is reported only for new consumer credit business and loans to households for house purchases. Rates net of related charges are in fact better suited to evaluating the effects of changes in the stance of monetary policy. There are also problems in applying uniform definitions of bank commissions.

Each central bank constructs its national interest rates as averages of those reported by the sample banks, weighted by volume. The ECB then calculates the rates for the euro area as a whole. Those on outstanding amounts are weighted according to the corresponding items of the national banking industry balance sheets. For new business, the volumes to be used as national weights are estimated by the respective NCBs using the data supplied by the reporting banks.

In Italy interest rate developments have mainly been analyzed using data from a sample survey instituted in the late 1970s and revised in 1995. The new reporting framework differs from the old one in significant respects. Under the ECB Regulation the rates charged to households and non-financial corporations are observed as separate categories. In most cases the old,

cont. ➤

with the same period of 2002, to €8.6 billion. By contrast, the volume of repo trading continued to grow rapidly, with average daily turnover rising by 14.9 per cent to €49 billion. The vigorous expansion of this segment of the secondary market, which is also paralleled by developments on other European markets, is attributable to a shift of trading from the traditional over-the-counter channel to electronic platforms, as well as to the growing use of repos in treasury management and securities lending.

The acute uncertainty bearing on interest rates sustained average daily turnover in futures on three-month euro deposits and in those on ten-year Bunds, both of which expanded by around 35 per cent from *unharmonized data covered all customers, including insurance and financial companies and government bodies. As for maturities, the new statistics are gathered for deposits of up to one year, one to two years, and beyond two years, and for outstanding loans of maturity up to one year, one to five years, and beyond five years. Previously, Italy distinguished only between short and medium-long term, the divide generally being at 18 months' maturity. Further, for new loans the harmonized statistics refer to the interval for which the contract does not provide for changes in the rate ("the initial period of rate fixation"). Italy's previous definitions considered the original maturity. The sample for harmonized rates is larger (125 intermediaries surveyed at the outset, compared with 102 in the old sample) and also includes banks specializing in one or a few types of financial product (such as home mortgages and consumer credit).*

As noted, the data on interest rates in the euro area will be available only as of December, so systematic international comparisons are not yet possible. As far as Italy is concerned, for proper comparison it will be helpful to describe the differences with respect to the previous time series.

For average rates on the outstanding amounts of deposits, the differences are minor. Over the first nine months of 2003 the rates paid to households and non-financial corporations were just 2 basis points lower according to the new statistics than the old, unharmonized average for all non-bank customers. For overnight deposits, the new rate was 10 basis points lower. The new rates are lower chiefly because of the exclusion of government entities and financial companies.

The change in the customer base affects the data for lending rates more significantly. Over the nine months the rate on the outstanding amounts of loans of less than 18 months' maturity under the unharmonized statistics (including overdrafts) was on the average 80 basis points lower than the new rate on loans with original duration of less than a year, because loans to government entities and to financial companies carry lower rates than those to other borrowers.

Turning to rates on new medium and long-term loans, the differences between the old and new systems also depend on a change in the definition of the time frame from the original maturity to the initial period of rate fixation. Rates on financing to non-financial corporations with a contractual rate duration of more than 12 months were 11 basis points lower under the harmonized statistics than under the previous definition for medium and long-term loans.

For credit to households the two series are basically not comparable. The problems derive from the change in the definition of the household sector to include producer households, and from the greater importance now attached to the purpose of the loan. The new sample, which covers at least 80 per cent of funds disbursed for each category of loan, represents about 85 per cent of all loans to households other than those for house purchases, compared with 55 per cent under the 1995 sample.

The Eurosystem plans to reconstruct comparable time series in the course of 2004 both for the area and country-by-country. Where possible, it will reconcile the old and new data.

the year-earlier period to €540 billion and €115 billion respectively.

Bank and corporate bonds

Bond issues in the euro area began growing again in February. Supply was encouraged by very low financing costs, partly as a consequence of a decrease in credit risk premiums, which had increased sharply in 2002.

In the first half of the year net bond issues in the euro area totaled €187 billion, slightly less than in the same period of 2002 (Table 32) but still one of the highest figures on record. By comparison with

Table 31

Stocks and net purchases of securities issued by residents in Italy, by holding sector (1)

(millions of euros)

	Public sector securities						Corporate bonds	Total public sector securities and corporate bonds	Listed Italian shares
	BOTs	CTZs	CCTs	BTPs	Other (2)	Total			
					Net purchases January-June 2003				
Central Bank	15	32	529	-533	. .	42	. .	42	-140
Banks	4,857	655	-2,051	-1,580	-135	1,746	2,157	3,903	-940
Investment funds (3)	8,839	-840	6,844	-1,039	163	13,966	226	14,192	-1,253
Other investors (4)	8,625	3,670	-6,728	14,576	9,915	30,059	25,297	55,356	6,310
of which: non-residents	*15,943*	*3,476*	*732*	*28,141*	*9,730*	*58,022*	*9,142*	*67,164*	*-11,341*
Total	**22,335**	**3,517**	**-1,406**	**11,424**	**9,943**	**45,813**	**27,680**	**73,493**	**3,977**
					Stocks at end-June 2003				
Central bank	195	213	9,246	30,345	1,070	41,069	164	41,233	4,801
Banks	21,219	5,277	45,221	22,741	4,918	99,376	52,300	151,676	26,275
Investment fundsi (3)	26,166	6,579	40,066	64,052	2,275	139,138	10,671	149,809	16,133
Other investors (4)	88,495	51,582	116,976	563,145	99,470	919,667	460,600	1,380,267	423,236
of which: non-residents	*78,478*	*28,408*	*47,877*	*359,969*	*92,662*	*607,394*	…,	…,	*50,969*
Total	**136,075**	**63,650**	**211,509**	**680,283**	**107,733**	**1,199,250**	**523,735**	**1,722,985**	**470,444**
Percentage share of total public sector securities	**11.3**	**5.3**	**17.6**	**56.8**	**9.0**	**100**			

(1) Stocks of public sector securities and corporate bonds are at face value and those of shares at market value; net purchases are at market value. Rounding may cause discrepancies in totals. – (2) Includes Republic of Italy loans and other public sector securities. – (3) Figures for Italian harmonized investment funds and SICAVs. – (4) Households, enterprises, non-residents, central and local government, social security institutions, *Cassa Depositi e Prestiti*, Italian investment firms and insurance companies; the figures for shares are estimated.

Table 32

Net bond issues by Italian and euro-area banks and firms

(millions of euros)

	2001	2002	2002		2003	
			Jan.-June	July-Sept.	Jan.-June	July-Sept.
			Italy			
Banks	33,917	33,239	24,072	4,313	12,558	2,591
Other financial firms	36,519	27,618	7,788	5,745	16,160	1,394
Non-financial firms	6,995	6,935	4,369	1,802	2,009	-382
Total	77,431	67,792	36,229	11,860	30,727	3,602
			Euro area			
Banks	196,687	134,062	114,311	26,209	83,374	….
Other financial firms	113,483	115,525	45,526	10,921	54,989	….
Non-financial firms	80,933	29,985	24,710	3,338	48,299	….
Total	391,103	279,572	184,547	40,468	186,662	….

Sources: Bank of Italy and ECB.

(1) Bonds with a maturity at issue of more than one year, valued at face value, issued by companies resident in the area and belonging to the sector indicated. The nationality and sector refer to the issuer and not to its parent company.

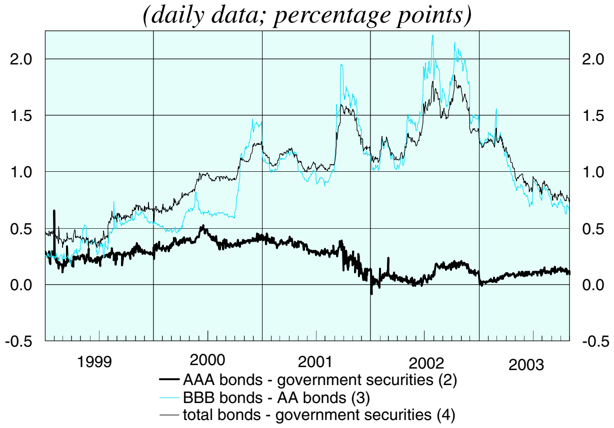
the first half of 2002, the share of issues made by non-financial enterprises and by non-bank financial corporations rose while that of the banks fell.

In Italy, by contrast, net bond issues contracted in the first nine months from a year earlier to €34.3 billion. The fall was substantial for both banks and non-financial firms, particularly telecommunication companies, which in the previous years had made large issues to finance corporate restructurings. On the other hand, net issues by non-bank financial corporations rose considerably, principally as a consequence of substantial securitizations of mortgage loans and INPS claims for social security contributions.

Figure 44

Yield differentials for the euro-denominated bonds of differently-rated issuers (1)

(daily data; percentage points)



Source: Based on Merrill Lynch data.

(1) Yields on fixed-rate euro-denominated Eurobonds with a residual term to maturity of not less than one year issued by non-financial firms resident in countries whose long-term foreign currency debt bears a rating not lower than Baa3 or BBB-. – (2) Yield differential between AAA-rated bonds and French and German government securities. – (3) Yield differential between BBB-rated and AA-rated bonds. – (4) Yield differential between all bonds issued by the non-financial sector with a rating not lower than Baa3 or BBB- and French and German government securities.

On the international market, gross issues by euro-area residents grew by 19 per cent in the first nine months of the year (Table 33); around 60 per cent of the bonds were issued in Luxembourg. Gross international issues by Italian banks and firms were virtually unchanged from the same period of 2002; those by non-financial corporations, particularly in the telecommunications sector, decreased markedly.

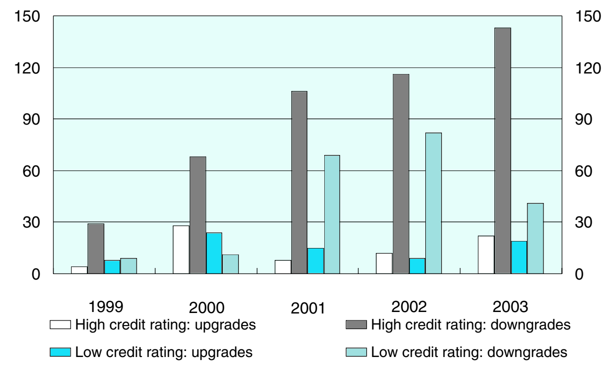
The drop in yields on low-rated securities encouraged issues of securities rated below BBB- or Baa3, which increased from 2 to 8 per cent of total issues by the non-financial sector of the euro area.

The premiums for credit risk diminished. The yield differential between euro-denominated bonds of the private non-financial sector and government securities came down by around one percentage point from the high reached in October 2002, falling to 0.8 percentage points and then stabilizing at that level from June onwards (Figure 44). There was also a large decrease in the premiums on credit default swaps. The decline in credit risk premiums reflected the drop in issuers' defaults and the spread of expectations of improvement in financial conditions thanks to the low costs of financing and the prospects of an international economic recovery. The ratings assigned to issuers by rating agencies also improved. According to Moody's, in the first nine months of 2003 the default rate in the international bond market fell from 2.5 to 1.3 per cent. In the euro area, in particular, compared with the year-earlier period the total number of upgrades rose and that of downgrades fell (although the latter were again far more numerous than the former; Figure 45).

Figure 45

Revisions of credit ratings of euro-area non-financial firms (1)

(number of revisions in the first nine months of the year)



Source: Moody's.

(1) Revisions for all classes of rating of long-term debt by Moody's. Companies with high (low) credit rating are those rated at least (lower than) Baa3: the rating considered is that assigned before the revision.

The reduction in credit spreads and in the premiums on credit default swaps was particularly

Table 33

Gross Eurobond issues by private sector companies (1)

(number of issues; amounts in millions of euros)

	1997	1998	1999	2000	2001	2002	2002 Jan.-Sept.	2003 Jan.-Sept.	2003		
									Q1	Q2	Q3
					Italy						
Number of issues	37	41	106	194	264	198	137	143	58	59	26
Value of issues	5,898	9,530	43,494	49,400	76,332	50,502	33,527	34,680	15,552	13,271	5,857
of which: by non-financial firms	*2,157*	*5,056*	*26,694*	*13,819*	*26,891*	*13,705*	*11,637*	*7,911*	*3,400*	*2,400*	*2,111*
					France						
Number of issues	88	57	170	214	206	216	178	215	61	94	60
Value of issues	14,881	10,628	45,169	48,620	56,262	61,437	47,795	59,318	15,757	29,562	13,999
of which: by non-financial firms	*3,691*	*3,139*	*28,231*	*25,151*	*32,699*	*28,451*	*23,483*	*33,193*	*5,209*	*20,306*	*7,678*
					Germany						
Number of issues	260	294	605	660	475	421	337	372	127	127	118
Value of issues	38,410	47,766	109,887	142,213	131,364	110,378	96,490	91,082	30,712	40,416	19,954
of which: by non-financial firms	*4,369*	*7,626*	*18,497*	*45,783*	*54,769*	*51,903*	*46,584*	*42,337*	*13,187*	*20,806*	*8,343*
					Euro area						
Number of issues	746	702	1,394	1,757	1,730	1,766	1,323	1,513	462	596	455
Value of issues	100,182	118,271	305,946	393,029	425,964	366,283	290,260	346,099	115,055	141,245	89,799
of which: by non-financial firms	*13,405*	*25,795*	*98,052*	*126,853*	*144,058*	*110,840*	*94,285*	*102,494*	*28,119*	*48,787*	*25,588*

Source: Based on Dealogic data

(1) Medium and long-term bonds issued by private sector borrowers belonging to a corporate group resident in the country or area indicated, at face value; includes private placements and issues placed simultaneously in the Eurobond market and in the US domestic market. Non-financial firms are classified according to the sector to which the parent company belongs. Amounts raised before 1999 have been translated into euros at the exchange rate of the euro applicable at 1 January 1999.

accentuated for the telecommunications and automobile sectors, which in the past had been penalized heavily by the cyclical downturn and the high debt burden of issuers. Among financial corporations, the reduction in differentials was largest for investment banks and insurance companies, which presumably benefited from the improvement in the securities markets (Figure 46).

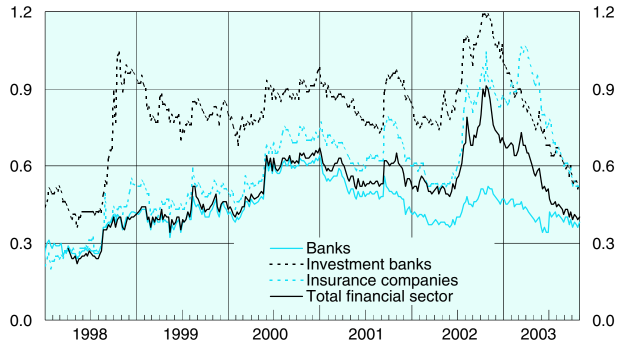
The stock markets

Share prices in the euro area began rising again in March, in line with the trend in the other main international stock markets (Figure 47). However, the number of newly-listed companies has continued to decline.

Figure 46

Yield differentials between euro-denominated bonds issued by financial firms and government securities (1)

(weekly data; percentage points)



Source: Based on Merrill Lynch data.

(1) Yields on fixed-rate euro-denominated Eurobonds with a residual term to maturity of not less than one year issued by financial firms resident in countries whose long-term foreign currency debt bears a rating not lower than Baa3 or BBB-. Yield differentials are calculated by reference to French and German government securities.

In the first ten months of the year the Dow Jones Euro Stoxx index of the largest listed companies of the euro area rose by 12 per cent. Share prices increased by 29 per cent in Germany, 19 per cent in Spain, 11 per cent in Italy and 10 per cent in France. Larger gains were recorded for the securities listed on the markets reserved to technology firms, ranging from 22 per cent on Italy's Nuovo Mercato to 57 per cent on the UK's Techmark.

The downward revision of risk premiums is likely to have contributed to the recovery in share prices. The volatility implied by the prices of stock index options, which had remained very high from the summer of 2002 until the start of military operations in Iraq in March, fell back to relatively moderate values both in the euro area and in the United States from June onwards.

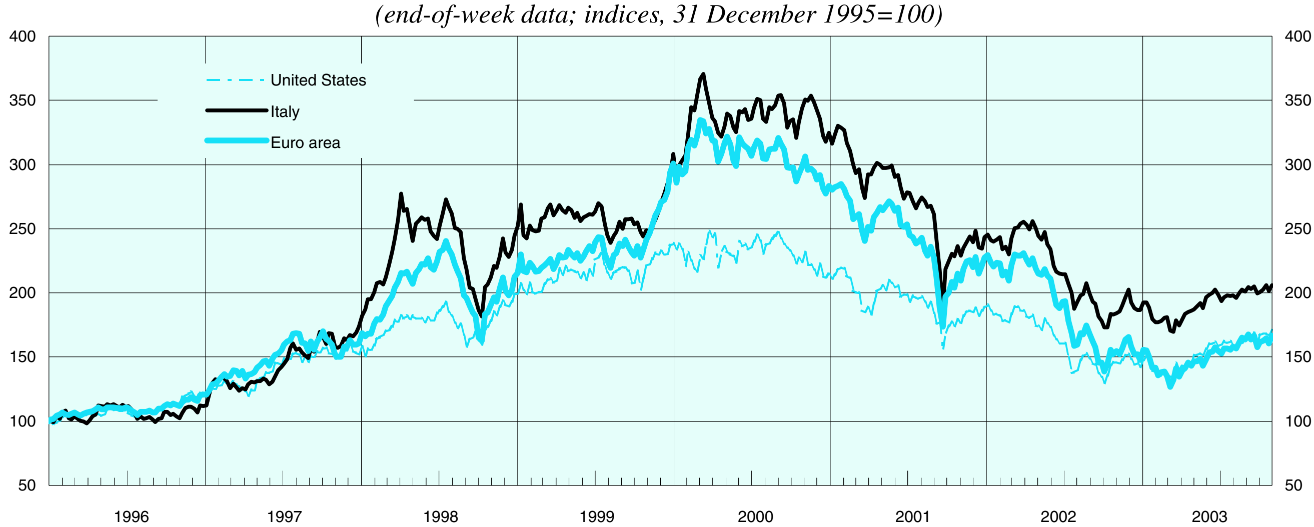
The stock market recovery was also fueled by the gradual consolidation of the prospects of an international economic upturn, which had a positive impact on the expected profitability of listed companies. In the euro area, the improved profit outlook was nonetheless limited to the high-technology and telecommunications sectors.

The ratio of companies' current earnings to share prices has fallen since the start of the year in all the main markets except Italy (Figure 48). In the principal countries of the euro area, the current earnings/price ratio now stands at the average level of the first half of the 1990s; in the United States, by contrast, it remains lower. According to IBES, the expected growth in US corporate earnings over a five-year horizon began to fall in the autumn of

Figure 47

Share prices (1)

(end-of-week data; indices, 31 December 1995=100)



Source: Bloomberg.

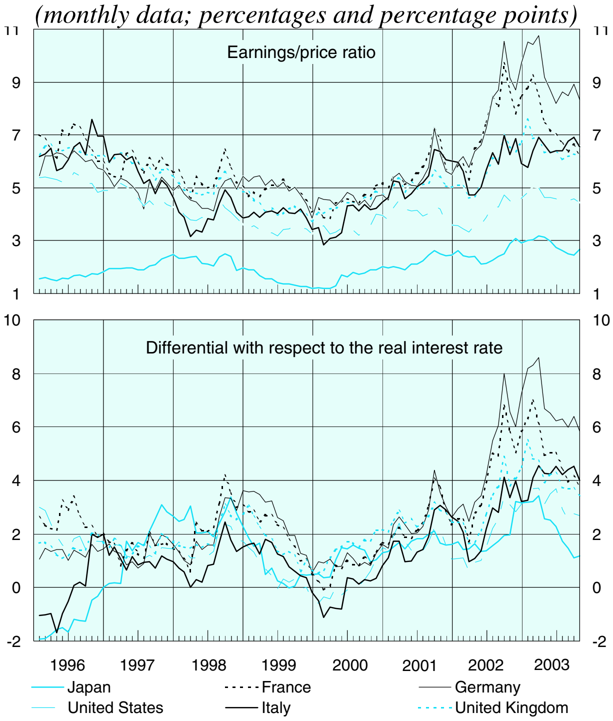
(1) MIB for Italy, Dow Jones Euro Stoxx for the euro area, Standard & Poor's 500 for the United States.

2000 and continued downwards until June 2002, subsequently stabilizing at the average level of the five years from 1990 to 1994.

Figure 48

Current earnings/price ratio on the main stock exchanges and differential with respect to real ten-year interest rates (1)

(monthly data; percentages and percentage points)



Sources: Thomson Financial, Bank of Italy and *Consensus Forecasts.*

(1) Real interest rates are calculated by deflating the nominal yields on ten-year benchmark government securities by expectations of consumer price inflation over the same time horizon.

In the euro area, the rise in share prices from the start of the year has been pronounced for companies in the technology, media and telecommunications sector (25 per cent) and the automobile industry (20 per cent), whose balance sheets, characterized by high debt, have benefited strongly from the very low level of interest rates. The rise in bank shares (24 per cent) also reflects the general improvement in the economic climate, as well as the dissipation of fears about the health of the banking systems in several large foreign countries.

On the Italian stock exchange, the indices of the telecommunications and automobile sectors have remained almost unchanged, in contrast with the upward trend in the area. Italian bank shares, up by 31 per cent, have benefited from the rise in profitability of several large groups and the prospects of a greater volume of securities intermediation kindled by the recovery of the share markets.

The number of new listings in the euro area has fallen further. In the first half there were 11, compared with 33 a year earlier. In the United States the contraction was even larger (19 new listings, down from 99). In Italy four companies have gone public since the beginning of the year, as in the same period of 2002.

Table 34

Net assets and fund-raising of investment funds controlled by Italian intermediaries (1)

(millions of euros)

	2001	2002	2002 Jan.-Sept.	2003 Jan.-Sept.
	Net assets *(end-of-period data)*			
Italian funds	403,689	360,557	387,475	381,827
Foreign funds (2) ...	105,079	97,536	93,750	112,001
Total	**508,768**	**458,093**	**481,225**	**493,828**
	Net fund-raising *(flows)*			
Italian funds	-20,365	-12,340	-11,378	14,050
Foreign funds	18,117	4,371	1,499	10,797
Total	**-2,248**	**-7,969**	**-9,879**	**24,847**
	Gross fund-raising *(flows)*			
Italian funds	218,576	190,254	143,597	162,260
Foreign funds	97,174	87,109	65,488	68,748
Total	**315,750**	**277,363**	**209,085**	**231,008**

Sources: Bank of Italy and Assogestioni.

(1) The figures refer to harmonized investment funds. The data for the last few months of 2003 are provisional. – (2) Value of units subscribed by Italian investors.

In September the total market value of the 260 resident companies listed on the Italian stock exchange amounted to 35 per cent of GDP, slightly less than at the beginning of the year. The corresponding ratios were 34 per cent in Germany, 63 per cent in France, 120 per cent in the United kingdom and 121 per cent in the United States.

In the first ten months of the year combined average daily turnover on the main market and the Nuovo Mercato was somewhat larger than in 2002; as a proportion of stock market capitalization, it rose from 0.5 to 0.6 per cent.

Investment funds

In the first nine months of the year investment funds controlled by Italian intermediaries received a substantial net inflow of €24.8 billion, compared with a net outflow of €9.9 billion in the same period of 2002 (Table 34), continuing the trend under way since the last quarter of 2002.

Although funds specialized in short-term assets received the bulk of subscriptions, “flexible” funds, whose investment policies are subject to less restrictions, also recorded a net inflow. From June onwards equity funds’ net flows turned positive, albeit by a small margin.

In the first ten months of the year the average total return of Italian investment funds was 2.5 per cent. (In 2002 the index of funds had lost 9.1 per cent, falling for the third consecutive year.) The positive result mainly reflects the recovery of the share market; equity, flexible and balanced funds achieved average yields of 9.3, 5.8 and 4.2 per cent respectively. By contrast, bond and money-market funds, affected by the low level of interest rates, recorded very modest returns: 1.6 and 1.4 per cent respectively.

At the end of September the net assets of investment funds established by Italian intermediaries amounted to €493.8 billion, 7.8 per cent more than at the end of 2002. Italian funds accounted for 77.3 per cent of the total, slightly less than a year earlier.

SHORT-TERM ECONOMIC PROSPECTS

The world economy

After stagnating between the autumn of 2002 and the spring of this year, the world economy began to grow again, although the strength of the expansion differed by region. Activity picked up in the United States and Asia from the second quarter onwards, while signs of recovery appeared in the euro area. Expansionary economic policies contributed to the improvement.

In the United States, the rapid growth in output in the third quarter (7.2 per cent at an annual rate) was sustained by the rise in private consumption stemming from tax cuts and by investment, which accelerated sharply.

Business confidence improved significantly in October. Private forecasters expect GDP to grow at an annual rate of between 3 and 5 per cent in the fourth quarter. The waning of the fiscal stimulus is expected to cause consumption growth to slow, but investment should continue its robust expansion. GDP is projected to grow by about 3 per cent for the year. The consolidation of the expansion will depend on employment continuing to rise following the upturn of September and October.

The US economy's potential for growth is considerable. In the first three quarters, hourly labour productivity increased by 3.9 per cent with respect to the year-earlier period. Between 2000 and 2002 productivity gains had averaged 3.4 per cent.

The still markedly expansionary stance of economic policy and the improvement in financial conditions and corporate profitability form the basis for rapid US growth in 2004 as well. Leading forecasters expect GDP growth on the order of 4 per cent.

Over the longer term, however, the sharp deterioration in the public finances and balance-of-payments developments are a source of concern. According to the most recent estimates of the Congressional Budget Office, the federal budget deficit will rise from 3.5 per cent of GDP in 2003 to 4.3 per cent in 2004. And while the private sector's financial deficit has diminished, the balance-of-payments deficit on current account is expected to remain at the high level reached in the second quarter (5.1 per cent of GDP) on average for 2003. At the end of the year, the country's net debtor position will exceed 25 per cent of GDP. The IMF's medium-term scenario indicates that at present exchange rates with the main currencies the current account deficit will narrow by just 1 percentage point of GDP over the next three years because of the stronger growth of demand in the United States than in the other major economies. As international organizations have repeatedly pointed out, raising the level of potential output of the euro-area economies through structural reforms would produce a larger correction of the imbalances.

In Japan the recovery that began last year is expected to continue in 2004, although forecasters disagree as to its strength. Projections vary from 1.2 to 2.9 per cent growth on average for the year. The longer-term outlook for the growth of the Japanese economy remains clouded by the state of bank balance sheets and profits and the growing imbalances in the public finances.

After slowing in the second quarter of 2003, activity in the emerging Asian economies is gathering pace again. Output is expected to grow by between 6 and 7 per cent in 2004, sustained by expansionary economic policies and, above all, the strong growth of trade within the area. In China, GDP should continue to expand, at a forecast rate of about 8 per cent.

After weak growth in the first half of the year, economic activity in Latin America is expected to

Table 35

Forecast performance of selected international macroeconomic variables
(percentage changes on previous year unless otherwise indicated)

	2003 (1)	2004 (1)					
	Consensus Forecasts	IMF	European Commission	Professional forecasters			
				Consensus Forecasts	Crédit Suisse First Boston	JP Morgan	Deutsche Bank
	10/11/03	Sept. 2003	Oct. 2003	10/11/03	14/11/03	14/11/03	14/11/03
GDP (2)							
United States	2.9	3.9	3.8	4.2	4.1	3.9	4.9
Japan	2.4	1.4	1.7	1.3	1.2	2.9	1.9
Euro area	0.5	1.9	1.8	1.7	2.3	2.3	1.8
Emerging economies	4.8 (3)	5.4	–	–	–	5.3	–
Asia	*5.9* (3)	*6.2*	*6.7*	–	*7.1*	*6.3*	–
of which: China	*8.5*	*7.5*	*8.0*	*7.9*	–	*8.0*	*8.0*
Latin America	*1.3*	*3.6*	*3.4*	*3.7*	*3.5*	*4.2*	–
Consumer prices							
United States	2.3	1.3	1.4	1.7	1.4	1.4 (4)	1.0
Japan	-0.3	-0.6	-0.4	-0.4	-0.3	-0.2 (4)	-0.3
Euro area	2.0	1.6	2.0	1.6	1.8	1.2 (4)	1.7
Emerging economies	6.1 (3)	5.2	–	–	–	5.0 (4)	–
Asia	*2.3* (3)	*2.7*	–	–	*2.6*	*3.0* (4)	–
of which: China	*0.8*	*1.5*	–	*1.4*	–	*3.4* (4)	*1.5*
Latin America	*7.9* (5)	*7.0*	–	*7.2* (5)	*6.5*	*6.6* (4)	–
World trade (2)(6)	**2.9** (3)	**5.5**	**7.3** (7)	**–**	**–**	**–**	**–**
Oil prices							
Average of the three leading grades ($ per barrel)	28.5 (3)	25.5	25.6 (8)	25.8 (9)	–	–	–

Sources: IMF, *World Economic Outlook*, September 2003; European Commission, *Economic Forecasts*, Autumn 2003; *Consensus Forecasts*, 10 November 2003; *Asia Pacific Consensus Forecasts*, 10 November 2003; Crédit Suisse First Boston, *Global Economic & FX Weekly*, 14 November 2003; JP Morgan, *Global Data Watch*, 14 November 2003; Deutsche Bank: *US Economics Weekly*, 14 November 2003, *Focus Europe*, 17 November 2003, *Japan Weekly*, 7 November 2003 and *World Outlook*, 24 September 2003.

(1) Forecasts. – (2) At constant prices. – (3) IMF forecasts. – (4) Change between fourth quarter 2003 and fourth quarter 2004. – (5) Change for the twelve months ending in December. – (6) Goods and services. – (7) Goods. – (8) Brent. – (9) WTI; end-November price.

strengthen, benefiting from the improvement in financial conditions. GDP growth, put at 1.3 per cent for 2003, is expected to accelerate next year, with forecasts ranging from 3.4 to 4.2 per cent.

The euro area

Economic activity in the euro area, already slowing in the second half of 2002, stagnated in the first half of this year.

The appreciation of the euro and the sluggishness of world demand caused a decline in exports in all the main economies of the area, while overall imports were stationary. The net effect of foreign trade was to decrease GDP growth by 1.5 percentage points on an annual basis.

A moderate impulse to growth came from stockbuilding and household consumption. Continuing uncertainty over the strength and timing of a cyclical upturn, together with the low capacity utilization, resulted in a decline in capital formation.

The long phase of rising employment since 1995 came to a halt.

The rise in per capita labour costs was moderate in all the main countries; given modest productivity gains, this helped to curb the increase in unit labour costs.

The containment of costs and the curbing of import prices thanks to the appreciation of the euro fostered a reduction in inflation over the first nine months. In all the major economies except Italy core consumer price inflation slowed down by comparison with 2002, holding at around 2 per cent since summer.

The effective exchange rate of the euro is now about 7 per cent higher than at the beginning of the year. Monetary conditions in the area remain strongly expansionary. The minimum rate on the Eurosystem's main refinancing operations was reduced to 2 per cent in June, the lowest rate since the start of stage three of EMU. Real short-term interest rates are now barely above zero. Market expectations are that they will increase gradually over the next year owing to a moderate rise in nominal rates but will remain below 1 per cent.

Euro-area M3 continues to expand rapidly, outpacing the growth of nominal GDP. The slowdown in August and September indicated by the seasonally adjusted figures may signal a lessening of the uncertainty that in the past two years has been a factor sustaining the strong preference for liquidity. Since July lending to the private sector has been accelerating.

Industrial production in the area is now growing again. In the third quarter GDP returned to growth, increasing by 1.5 per cent on an annual basis.

The *Consensus Forecasts* November projections indicate a gradual recovery in economic activity over the next few quarters in connection with the world economic upswing. This year GDP growth is not likely to exceed 0.5 per cent; it is expected to average just over 1.5 per cent in 2004. All the components of internal demand are expected to show an acceleration. By mid-year the annual rate of economic growth should pick up to between 2 and 2.5 per cent. Consumer price inflation is expected to hold at an average of 2 per cent in 2003 and to decline to 1.6 per cent in 2004. The slowdown is expected to stem mainly from the appreciation of the euro. There may be transitory price pressures owing to planned indirect tax measures.

A further increase in area-wide general government net borrowing is projected. According to the European Commission's estimates, the deficit will rise to 2.8 per cent of GDP this year, from 2.2 per cent in 2002 and 1 per cent in 2000. The ratio of debt to GDP is projected to rise.

In Germany and France deficits are likely to stay above the 3 per cent ceiling for the second consecutive year, reaching 4.2 per cent of GDP in both countries. Deficits ranging between 2.6 and 2.9 per cent are forecast for Italy, the Netherlands and Portugal.

In October the European Commission voted two Recommendations on France for submission to the Council at its 25 November meeting. The Commission observed that the French Government had not taken effective deficit correction measures and called for a budget adjustment for 2004 larger than is currently planned. Considering the sudden, unexpected deterioration of the economic situation, the Commission proposed to extend the deadline for bringing the deficit back under the 3 per cent limit until 2005. Similar action by the Commission vis-à-vis Germany is expected.

The imbalances in the public finances in the main countries of the area reflect not only the economic downturn but also the tax cuts enacted in the past years and the delay in adopting stringent measures to curb expenditure.

The Italian economy

In Italy GDP declined slightly in the first half of the year, after an increase in the second half of 2002 in connection with the tax incentives for investment and for the purchase of cars.

Economic activity was fueled by stockbuilding and, to a lesser extent, by household consumption, which grew more slowly than in the second half of 2002. There was a contraction in investment, of about the same magnitude as its expansion in the second half of 2002.

Net exports continued to have a negative effect on growth. Italian exports fell more sharply than those of the other major euro-area economies; the deterioration in price competitiveness, more pronounced than in France and Germany, was a contributory factor.

The external current account deficit widened; Italy's international investment position is negative by around 8 per cent of GDP.

The Italian economy is still beset by unsolved structural problems that are reflected in the decline in productivity and the weakness of its model of specialization, which is more exposed to the competition of the emerging countries and less oriented towards the dynamic segments of world demand. This results in greater vulnerability during international downturns and reduced ability to benefit from expansions of world demand.

Despite the moderate growth in nominal wages, the fall in productivity led to a larger increase in unit labour costs than in the other countries of the euro area.

The twelve-month rate of change in consumer prices remained close to 3 per cent in the first nine months of the year, widening the differential vis-à-vis the area average. This divergence is mainly the result of higher inflationary pressure in the service sector, together with increases in some regulated prices.

The number of persons in work rose further in the first half of 2003, despite the stagnation of economic activity. However, the labour force survey found that labour demand was stationary in the second quarter.

In 2003 the growth in self-financing of non-financial enterprises appears limited. Given the fall in investment, the financing requirement in the first half was in line with last year's level.

Lending to the private sector continues to expand rapidly for both households and firms, outpacing the area average; in the last few months its growth has accelerated, boosted mainly by credit to firms. Lending conditions remain generally easy, even if banks have grown more prudent in granting credit to riskier borrowers. Although the amount of new bad debts has grown during the year, their ratio to the stock of loans outstanding has remained at low levels, similar to those of 2002; the ratio has increased slightly in the South, while it has remained basically stable in the Centre and North.

Banks' operating result in the first half was unchanged from the same period of 2002; there are signs of an improvement in the result for the third quarter. The return on equity is slightly higher than in 2002.

Italian banks' exposure to interest rate and exchange rate risk remains limited; the costs stemming from credit risk are down from last year's high levels.

In September the Government estimated the state sector net borrowing requirement for 2003 at €45 billion (3.5 per cent of GDP) and general government net borrowing at €32.9 billion (2.5 per cent). This would widen the difference between the two balances, which had been held to 0.4 percentage points in 2002 by one-off financial measures.

In the first ten months of the year the state sector net borrowing requirement amounted to €54.8 billion, €5.5 billion more than in the corresponding period of 2002. Taking account of the securitization in November of claims receivable by the State Sector Employees' Social Security Institute and of the further receipts to come from tax regularization schemes in the last part of the year, the trend of the borrowing requirement appears to be consistent with the September estimate.

According to the Government's estimates, the ratio of debt to GDP should fall from 106.7 per cent in 2002 to 106 per cent this year. In order to achieve this result, the Government is adopting financial measures.

The budget for 2004

According to official estimates, the budget proposals for 2004 will reduce general government net borrowing compared with the budget on a current legislation basis by some €11 billion, or about 0.8 per cent of GDP. The reduction is the result of a net increase in revenue of €12.1 billion and a net increase in expenditure of €1.1 billion. In addition to the measures in the Finance Bill, which increase the deficit by €2.6 billion, the adjustment includes the net decrease of €13.6 billion that the measures contained in Decree Law 269/2003 are expected to produce.

Increase in revenue. *– The additional revenue expected amounts to €14.3 billion and is mostly of a one-off nature (see table).*

The continuation of the sales of public real estate is expected to bring in €5 billion.

Some €3.6 billion of additional revenue is expected from the so-called ex ante tax agreement. Pending the implementation of the mechanism on an individual basis, the decree provides for a temporary version for 2003 and 2004 incomes. The measure is aimed at firms and self-employed workers in business at 31 December 2000 whose sales revenues in 2001 did not exceed €5,154,569. There are four advantages for taxpayers: a) application of lower tax rates for the part of taxable income in excess of that reported in 2001; b) suspension of the requirement to issue a tax receipt, unless requested to do so by the customer; c) a reduction in the authorities' power to assess taxpayers' taxable income; and d) exemption from the obligation to pay social security contributions on taxable income above predetermined ceilings. These advantages are subject to the minimum increases specified in the decree for both revenues and taxable income. Taxpayers whose payments did not comply with the sector study parameters in 2001 or, where these were not available, with the parameters established in Law 549/1995, may use the mechanism provided they first bring their revenues into line with the relevant parameters and pay the consequent additional taxes.

Estimated effects of the budget on the general government consolidated accounts (1)
(*millions of euros*)

REVENUE	
Increase in revenue	**14,310**
Sales of real estate (2)	5,000
Ex ante tax agreement (2)	3,580
Regularization of building offences (2)	3,090
Indemnities for occupation of state land (2)	460
Video games and betting (2)	670
Social security contributions (2)	630
Postponement of the reintroduction of tax regularization schemes (2) (3)	500
Other measures (2)	380
Decrease in revenue	**-2,180**
Bringing forward to 2003 of payments of excise duties (2)	-980
Extension of tax relief for agriculture (4)	-750
Extension of VAT deductibility for company cars (4)	-160
Extension to 2004 of excise duty reliefs (2)	-140
Other measures (2) (4)	-150
Net change in revenue	**12,130**
EXPENDITURE	
Decrease in expenditure	**-1,680**
Transformation of Cassa Depositi e Prestiti and SACE (2)	-890
Staff costs (4)	-500
Social security (2)	-100
Other current expenditure (2) (4)	-190
Increase in expenditure	**2,770**
Staff costs (4)	1,120
Workfare programmes (4)	350
Extension to 2003 of support for road hauliers (2)	320
International peace missions (4)	200
Support for families (2)	130
Other current expenditure (2) (4)	500
Capital expenditure (4)	150
Net change in expenditure	**1,090**
TOTAL REDUCTION IN PRIMARY NET BORROWING	**11,040**

(1) Based on official estimates. – (2) Measures contained in Decree Law 269/2003. – (3) The technical report accompanying the decree indicates that additional receipts amounting to €370 million are expected in 2005. – (4) Measures contained in the Finance Bill.

cont. ➤

The Decree also contains measures for the regularization of certain building works completed before 31 March 2003 that did not comply with the rules and regulations in force. The amount payable varies with the type of irregularity. This scheme is expected to bring in €3.1 billion, which will be supplemented by the indemnities payable for building works carried out on certain types of state land (€0.5 billion).

The taxation of video games and betting will undergo some changes that are expected to generate €0.7 billion of additional receipts. In turn, the deferment from 16 October 2003 to 16 March 2004 of the reintroduction of most of the tax regularization schemes provided for in the Finance Law for 2003 is expected to bring in €0.5 billion.

The measures concerning social security contributions are expected to bring in an additional €0.6 billion. Among other things, they extend the contribution requirement to "participating associates" and raise the contribution rate for certain categories of non-payroll employment to that in force for shopkeepers.

***Decrease in revenue.** – This is forecast at €2.2 billion and is mainly due to one-off measures. About €1 billion is the result of the early payment in 2003 of excise duties on mineral oils. The other measures, mainly aimed at firms, concern the extension to 2004 of some existing reliefs. The extension of the relief for the agricultural sector is expected to decrease revenue by €0.8 billion.*

The budget contains some measures whose effects on revenue will mainly be felt in 2005 and beyond. The most important include the temporary incentives granted to companies admitted to listing on regulated markets and the possibility for companies to deduct from corporate income, in addition to ordinary expenses, a part of their investment in R&D and the entire amount of the expenses they incur to participate in trade fairs abroad or to hold training courses for students or graduates. Lastly, provision is made for the extension to 31 December 2004 of the partial deductibility from personal income of building renovation costs (the lower VAT rate for such works has been extended to 31 December 2003).

***Decrease in expenditure.** – The proposals included in the Finance Bill are expected to reduce expenditure by €1.7 billion.*

The transformation of Cassa Depositi and Prestiti and SACE into public limited companies is expected to bring savings of respectively €0.8 and €0.1 billion.

The reduction in outlays for staff costs is expected to come from the renewal of the restrictions on the hiring of permanent employees (€0.3 billion) and the use of fixed-term contracts (€0.2 billion).

A reduction of €0.1 billion is expected to come from the change in the rules governing pensions for workers who have been exposed to asbestos.

***Increase in expenditure.** – The budget proposals are forecast to increase expenditure by €2.8 billion, of which €2.6 billion on current account.*

The contribution of staff costs is estimated at €1.1 billion, of which €0.7 billion deriving from the renewal of central government employees' contracts for 2004 and 2005. Another €0.3 billion refers to additional contractual costs in the health care system in 2002 and 2003.

An allocation of €0.4 billion has been made for workfare programmes and another of €0.3 billion to prolong the support for road hauliers. The increase in expenditure on international peace-keeping missions is estimated at €0.2 billion.

Additional support is to be provided to families through the introduction, for a limited period, of a benefit for each child born after the first and an increase in the allocation to the fund for social policies; taken together the two measures are expected to cost €0.1 billion.

Lastly, the increase in capital expenditure is the result of a series of allocations for projects in the ICT sector, action to be taken in conjunction with the reform of the structure of the school system and measures in support of goods produced in Italy.

After two negative results, in the third quarter GDP rose by 2 per cent on an annual basis according to Istat's preliminary estimates. Industrial production grew by an average of almost 1.5 per cent with respect to the previous quarter. It contracted in September and, according to estimates based on electricity consumption, again in October; data for the first fortnight of November point to a partial recovery.

During the summer, business expectations were for a moderate upturn in activity in the final part of the year. The Bank of Italy's September survey of industrial and service firms and the ISAE surveys indicate an improvement in the outlook for demand; it is accompanied by an improvement in consumer confidence. The civil engineering companies polled by the Bank of Italy's survey of firms operating in the public works sector report a slight decline in activity, which is attributable to delays and restrictions in the realization of the planned public works projects. Favourable developments are forecast for the final part of the year.

Overall, the available indicators suggest a small increase in GDP in the fourth quarter. On average for the year, the growth in output is likely to be on the order of 0.5 per cent.

The *Consensus Forecasts* survey of private forecasters in November predicts GDP growth of 1.5 per cent in 2004, slightly less than that expected for the euro area as a whole.

Consumer price inflation, slowing sharply from the current year thanks especially to the appreciation of the euro, is forecast to fall to 2.1 per cent.

In September the Government broadly confirmed the estimate of the deficit on a current programmes basis published in the July Economic and Financial Planning Document, which was set at 3.1 per cent of GDP for 2004, and at the same time raised the target from 1.8 per cent to a less ambitious 2.2 per cent. The size of the correction was accordingly reduced from €16 billion to €11 billion. The package envisages €16 billion worth of deficit-reducing measures and €5 billion to support the economy. Overall, it is expected to raise revenue and expenditure by €12.1 billion and €1.1 billion respectively.

According to official estimates the ratio of primary current expenditure to GDP in 2004 will again be nearly 1 percentage point higher than in the second half of the 1990s. The capital expenditure ratio (net of privatization receipts and the effects of transforming the National Road Agency, ANAS, into a public limited company) is expected to remain broadly unchanged. The private sector may be able to help finance the Government's broad public works programme.

The baseline projection for the public accounts that underpins budget policy carries some risks. Economic growth in 2004 could be lower than the Government's assumption of 1.9 per cent. The planning document sets the state sector net borrowing requirement for 2004 at 3.7 per cent of GDP: the gap with respect to net borrowing would thus widen further.

For the third year running much of the correction consists in temporary revenue measures. If the lingering effects of measures decided in previous years is also taken into account, it can be estimated that expected temporary revenue for 2004 will amount to over 1 per cent of GDP, compared with around 1.5 per cent in 2002 and 2003.

The purpose of temporary measures is to reduce the negative impact of the adjustment on private sector expenditure decisions at a time of unfavourable economic conditions. Some of the provisions of immediate efficacy may entail costs or revenue losses in the future. The postponement of structural measures has an adverse effect on expectations. The repeated offer of amnesties for violations of tax and other regulations can generate uncertainty about the binding nature of legislation.

After 2004 the Government plans to reduce the deficit rapidly; the primary surplus, which is projected at less than 3 per cent of GDP in 2004, will rise steadily to 5.1 per cent in 2007, when the budget is also expected to achieve balance.

The prerequisite for achieving the objectives and pursuing the policy to reduce the tax burden is the adoption of structural measures in the area of current expenditure. A far-reaching reform of social security legislation is necessary. The innovations currently being developed can help to curb the tendency of outlays in this sector to grow in connection with the ageing of the population.

The Italian economy has the resources to resume more rapid growth than in the last decade. Solving the structural difficulties of the public finances, strengthening the tangible and intangible infrastructure, introducing reforms to stimulate innovation, human capital formation and growth in company size, and taking steps to improve the efficiency of public services, by increasing productivity and competitiveness, are the essential conditions for a return to growth.

Based on information available at 17 November 2003. The Appendix is updated to 8 November.

Articles

The growth of the market for Italian corporate bonds (*)

1. Introduction

Italian firms and banks have appreciably increased their international bond issues since the launch of the euro (Banca d'Italia, 2000,[1] and ECB, 2001). As in the case of the other European countries, this growth has been prompted by the annulment of exchange rate risk within the euro area, the low level of real interest rates and the financing of mergers and acquisitions. Tax considerations have continued to be a fundamental factor.

Over the long term, a backward glance shows that Italian firms have had limited recourse to the bond market. During the 1950s Governor Donato Menichella recommended more extensive financing of investment through share capital increases and direct bond issues, in the conviction that evaluation by the market led to an increase in firms' efficiency (Cotula, 1999). Bonds' share of the total flow of available funds for the private sector reached a peak of 17 per cent between 1963 and 1965 (Cotula, 1999). For a representative sample of firms, it has been estimated that the stock of bonds in circulation amounted to 6 per cent of total liabilities in 1965 (Barbiellini Amidei and Impenna, 1999).

In the 1970s and 1980s the huge growth in issues of government securities and high inflation, which eroded the value of the fixed-rate bonds that constituted the bulk of those in circulation, impeded the expansion of the market in private paper. The latter was therefore fueled almost exclusively by special tax advantages.

Together with the low capitalization of the stock exchange and the small number of listed companies, the limited size of the bond market is one of the distinctive features of the Italian financial market. On the basis of the financial accounts, bonds amounted to just under 2 per cent of non-financial firms' total financial liabilities in 2001 (Table a1), similar to the proportion in Germany but far smaller than in France (6 per cent), the United Kingdom (9 per cent) and the United States (14 per cent).[2]

In part, the limited use of direct fund-raising in the equity and bond markets by Italian firms reflects the prevalence of small and medium-sized enterprises; in 2001 bonds accounted for 2 per cent of financial liabilities of the firms with fewer than 200 employees surveyed by the Company Accounts Data Service, compared with 7 per cent for larger companies.

Economic literature has identified the existence of a causal relation between the growth of the financial system and that of the real economy (Jayaratne and Strahan, 1996; Rajan and Zingales, 1998; for a review of the literature, see Levine, 1997, and Pozzolo, 2003). Diversified and efficient financial systems assist economic growth by enabling entrepreneurs to procure capital with which to finance investment projects that are likely to yield high but deferred returns. In particular, developed financial markets channel resources more effectively to firms with greater growth potential,

(*) *Prepared by the Bank's Economic Research Department and Supervision Departments.*

thereby determining a better allocation of resources and faster total factor productivity growth (Wurgler, 2000).

This article documents the recent growth in bond issues by Italian firms, which, as in the other euro-area countries, has been concentrated almost entirely in the international market. Section 2 recalls the definition of international market and describes the characteristics of Italian firms' bond issues. Section 3 analyzes the sharp increase in defaults occurring in the international bond markets between 2000 and 2002 in connection with the cyclical slowdown of the world economy and the deterioration in corporate profitability. Section 4 describes the procedures followed by international financial intermediaries in Eurobond issues, with which the transactions of Italian issuers have also conformed. Section 5 summarizes the rules governing corporate bond issues and securities offerings in Italy, with particular reference to the distribution and trading of securities by intermediaries.

2. The growth of the bond market in Italy and the euro area since the launch of the euro

2.1 The size of the bond market in Italy and the euro area

The bond market of the euro area has changed radically and grown rapidly since the launch of the single currency, most notably through the increase in issues on the international market (as defined in Section 2.2).

Between 1998 and 2002 the ratio to GDP of the stock of resident companies' bond issues on the domestic and international market rose from 44 to 59 per cent in the euro area and from 28 to 47 per cent in Italy (Table 1 and Table a2). At the end of 2002 international issues made up two thirds of the volume of bonds issued by euro-area companies; in Italy the proportion was lower (less than half), essentially because most bank bonds are domestic issues.

Overall, the private bond market of the euro area is comparable in size to that of the United States, where, excluding the securities issued by government agencies,[3] the stock of bonds rose from 49 to 63 per cent of GDP between 1998 and 2002 (Table a2). A quarter of the issues made by US companies are aimed at the international market.

Table 1

Outstanding bonds of Italian and euro-area companies
(as a percentage of GDP)

	1998	2002
	Italy	
Banks	25	32
Other financial companies	0	7
Non-financial companies	3	7
Total	28	47
of which: international market	*4*	*20*
	Euro area	
Banks	36	43
Other financial companies	3	8
Non-financial companies	5	8
Total	44	59
of which: international market	*16*	*40*

For the methodological notes, see Table a2 at the end of this article.

In the euro area around half of the growth in the bond market is attributable to banks, which use the proceeds of bond issues to fund their loans. In 2002 bank bonds outstanding in the area amounted to 43 per cent of GDP (compared with 3 per cent in the United States), an increase of 7 percentage points on 1998.

Non-bank financial corporations also account for an appreciable share of the issues in the euro area. In the case of Italy the issuers are securitization special-purpose vehicles, and a large proportion of the transactions carried out involves public-sector entities (Section 2.4).

Recourse to the bond market by non-financial firms of the euro area has been increasing but continues to be far less than that by American firms. Between 1998 and 2002 the stock of securities issued by non-financial firms rose from 5 to 8 per cent of GDP (from 3 to 7 per cent in Italy); in the United States it increased from 25 to 29 per cent.

The growth in the bond market in the euro area has not been accompanied by a significant transfer of risk from the banks to savers.[4] Bank lending has continued to expand rapidly. Between 1998 and 2002 the stock of bank loans to firms rose from 38 to 42 per cent of GDP in the euro area and more sharply than that in Italy (from 37 to 43 per cent).

2.2 The international bond market

The international bond market consists of issues largely placed outside the issuer's country of residence, distributed by an underwriting syndicate and listed on one or more stock markets.[5] The international market can be divided into two segments, the foreign market and the Euromarket. Bonds issued in the foreign market are underwritten by a syndicate of banks resident in a country different from that of the issuer's registered office, distributed in the syndicate's country under its issue rules and denominated in its currency. The definition of Euromarket is based on the EU's Prospectus Directive (89/298/EEC)[6] and identifies Eurobonds as securities that: i) are underwritten and distributed by a syndicate at least two of the members of which have their registered offices in different states, ii) are offered on a significant scale in one or more states other than that of the issuer's registered office, and iii) may be subscribed for or initially acquired only through a credit institution or other financial institution.[7] Eurobonds are generally bearer securities, to preserve the anonymity of the owner, and are generally not subject to withholding tax if held by investors not resident in the country of issue.

Various factors besides the traditional tax advantages have contributed to the growth of Eurobond issues in a period of very low nominal and real interest rates. Some of these factors are structural, such as the great depth of the market made possible by the annulment of exchange rate risk between the countries of the euro area; others are contingent, such as the need of large firms to finance mergers and acquisitions and the strategies adopted by issuers with the aim of creating a sufficiently liquid secondary market in their own securities, to facilitate the placement of subsequent issues.

The rapid expansion of the international market is among the elements that have fueled discussion at EU level of the taxation of savings income. Non-residents are required to report bond interest paid to them abroad to their home-country tax authorities, but the scant efficacy of cross-checking has spurred the countries of the Union to seek coordinated forms of action. In its meeting of 3 June 2003 the Ecofin Council approved the tax package composed of the directive on the taxation of interest income, the Code of Conduct on taxation of businesses, and the directive on the taxation of interest and royalty payments between associated firms. The directive on the taxation of interest income confirms the ultimate objective of the automatic exchange of information, with the tax authorities of each country pledging to report the amount of interest payments received by non-residents to the latter's home-country tax authority. The directive is to be transposed into national law by 31 December 2003 and enter into force on 1 January 2005, provided that similar measures are applied by Switzerland, Liechtenstein, the Principality of Monaco, San Marino, Andorra and all the pertinent dependent or associated territories (Channel Islands, Isle of Man and dependent or associated territories of the Caribbean). However, instead of exchanging information, Austria, Belgium and Luxembourg will be able to apply a withholding tax for a transitional period whose duration will be determined on the basis of a decision of the Council of the European Union.

2.3 Issues by Italian firms in the international market

Between 1999 and 2002 the average annual volume of net bond issues by Italian firms was €16.5

billion, compared with €0.2 billion in the previous four years. The bonds were placed very largely on the international market, which had the necessary liquidity to absorb the issues; in the domestic market Italian firms made net issues only in 2001 and 2002, for a total amount of about €5 billion (Table 2).

Table 2

Net issues of bonds by Italian non-financial companies

(par values; millions of euros)

	1998	1999	2000	2001	2002
Domestic market	-3,385	-895	-5,395	3,494	1,420
International market	2,983	26,409	12,950	23,535	4,297
Total	**-402**	**25,514**	**7,555**	**27,029**	**5,718**

For the methodological notes, see Table a2 at the end of this article.

Between 1995 and the first half of 2003 Italian companies made 222 Euromarket issues amounting to €85.8 billion, or 15.5 per cent of the total amount issued by euro-area firms (Table a3).[8] The issues with an original maturity date subsequent to 30 June 2003 numbered 167 and amounted to €78.4 billion. A very substantial volume of Italian corporate bonds will reach maturity in 2004 and 2005: around €21 billion and €11 billion respectively (Figure 1). In the subsequent two years some €19 billion of securities will mature.

Since the introduction of the euro, it is easier for Italian firms to finance their investment projects in the bond market. Both the number of Italian issues and the average issue amount have grown significantly (Table 3). In the four years between 1999 and 2002 Italian firms made an average of 43 issues a year with an average issue amount of €440 million (compared with an average of 11 issues and €150 million in the previous four years).

In the other major euro-area countries there has been a similar increase in the number and amount of issues (Table 3). Between 1999 and 2002 there were 99 issues a year in France and 129 in Germany; the average issue amount was smaller than that of Italian issues (€290 million in France and €330 million in Germany).

Table 3

Gross issues of Eurobonds by non-financial companies of the leading euro-area countries

(averages of annual values; millions of euros and percentages)

	1995-1998	1999-2002
Italy		
Number of issues	11	43
of which: rated	*3*	*22*
Value of issues	1,657	18,718
of which: rated	*745*	*13,049*
share of area total	*11*	*16*
France		
Number of issues	14	99
of which: rated	*8*	*70*
Value of issues	2,327	28,913
of which: rated	*1,468*	*18,414*
share of area total	*20*	*25*
Germany		
Number of issues	31	129
of which: rated	*14*	*113*
Value of issues	4,254	42,738
of which: rated	*2,226*	*36,492*
share of area total	*34*	*35*

For the methodological notes, see Table a3 at the end of this article.

Overall, bond issues by Italian firms rose from 11 per cent of total euro-area corporate issues in the four years between 1995 and 1998 to 16 per cent in the subsequent four years, a figure in line with the Italian economy's share of the area-wide economy.

According to a 2001 study by the Bank's Economic Research Department, the expansion of the Euromarket has increased the number of firms that can use bond issues in order to finance their growth.

Among first-time issuers of Eurobonds since 1999 there is a high proportion of unlisted companies operating in technologically advanced sectors. Although their average size is large, it is considerably smaller than that of the companies that entered the market before 1999. There are also substantial differences between the characteristics of the securities issued by the two categories of issuers. As a rule, the companies entering the market after 1999 have made only one issue, compared with an average of seven for the other companies. The entry of smaller, less-well-known firms, many of them active in high-tech sectors, has been a positive development from the standpoint of allocative efficiency; it has been assisted by the participation of Italian banks in placement syndicates for 45 per cent of the total amount of the bonds issued by the new issuers, twice as large as the proportion in the case of the larger companies. Along with the decline in the average size of issuers, there has been an increase in the proportion of issues without a rating (94 per cent for the newcomers, compared with 33 per cent for the companies already present in the market).

To issue bonds, firms appoint one or more banks to organize the placement of the securities. Traditionally, Italian firms have largely used the services of foreign banks. Assuming that in placement syndicates the amount is equally divided among the participating banks, around 70 per cent of the value of bonds issued by Italian firms between January 1995 and June 2003 was placed by foreign investment banks (Table a4). JP Morgan and Lehman Brothers organized the placement of 37 per cent of the total volume, while the first four Italian groups involved in this activity (Mediobanca, IntesaBCI, Unicredito and San Paolo Imi) organized a quarter of the total. Foreign investment banks also handle a very large share of the issues made by German and French firms (68 and 57 per cent respectively).

The large role played by the major Anglo-Saxon investment banks in underwriting and placement syndicates in the international market tends to make for uniform practices and conditions, annulling segmentation between national markets.

Recourse to the international market has been very intense on the part of Italian telecommunications companies, which in the late 1990s were engaged in restructuring and investing in new technologies. The telecommunications sector accounts for more than half of the amount of bonds issued, while automobile companies and food-processing firms account for 17 and 12 per cent respectively (Table a5).

In Germany the automobile industry is the leading issuer (41 per cent), owing not least to the large issues made in the international market by US car makers controlled by German corporations. In France, by contrast, the concentration of issuers by sector is relatively low; the leading borrowers are the automobile and energy industries and large-scale retailing, all with shares ranging between 14 and 18 per cent.

For Italian firms the average original maturity of issues is more than five and a half years, similar to that of the issues of French and German firms; the distribution of issues according to the different classes of maturity is also broadly similar across countries (Table a6). Fixed-rate issues are prevalent everywhere, accounting for 58 per cent of the total amount in Italy, 55 per cent in France and 79 per cent in Germany (Table a7).

At issue, just under a third of the volume of bonds of Italian firms lacked a rating assigned by at least one of the three major rating agencies, Standard&Poor’s, Moody’s and FitchIBCA (Table a3). The proportion is similar to that in France (33 per cent) and higher than that in Germany (18 per cent). In terms of the number of issues, the percentage of unrated issues was much higher for Italian firms than for French and German firms (52 per cent, compared with 29 and 20 per cent); this was due in part to the higher incidence of small issues,[9] for which the expense of obtaining a rating substantially increases the cost of the issue.

Italian corporate bonds’ spreads at issue are in line with those on other countries’ corporate bonds. Figure 2 compares the yields at issue of Italian firms’ fixed-rate bonds denominated in euros, having regular features and a five-year maturity, with the market indices calculated by Merrill Lynch. Taking account of the rating of the issues, there do not appear to be significant differences with respect to the conditions prevailing in the international market.

Almost all of the bonds issued by Italian firms in the international markets are listed in Luxembourg (94 per cent of the total). The percentage is also very high for French, German and US companies (67, 71 and 55 per cent respectively).

Medium and long-term financing instruments, such as bonds, are usually utilized to support investment or for the consolidation of financial liabilities. An increase in bond issues may therefore be accompanied by a reduction in other forms of financing.

In recent years there has been a notable increase in the use of bridge loans, temporary financing provided to firms by a syndicate of banks. These loans are a means of quickly supplying liquidity to companies that have already planned a bond issue. The sharp rise in bridge loans is due to the fact that their disbursement takes less time than that needed to organize a bond placement.

Of all the bonds issued by Italian groups since 1998 and listed in Luxembourg, more than half refer to companies belonging to the Pirelli and Telecom groups and nearly 20 per cent in all to companies of the Fiat and Italenergia groups (Table 4).

Italian companies rank fourth among the firms of the G-10 countries in terms of the total amount of bonds listed in Luxembourg, with 10 per cent of the total (181 issues by 52 firms or groups for a value of around €80 billion). US firms rank first with 50.2 per cent, followed by German and French companies with 13.5 and 11.7 per cent respectively.[10]

In summary, the rapid growth in international bond issues by Italian firms between 1999 and 2002 is part of a trend common to the major euro-area countries and tends to favour the financing of investment and to make for a more balanced composition of corporate financial debt. The size and contractual conditions of Italian companies' issues are not substantially different from the characteristics prevailing in the international market.

2.4 Italian public-sector issuers

Euromarket issuance by Italian public-sector entities has also been intense. According to data published by specialized data providers, like the issues of private-sector companies the bonds of public-sector entities are generally placed by a syndicate of international banks and listed on the Luxembourg stock exchange; in some cases they have been issued through a foreign financial corporation (Table 5).

In the past large publicly-owned Italian firms were among the most active borrowers in the Euromarket. The first Eurobond issue was made in 1964 by Autostrade, with a guarantee from IRI. It was denominated in dollars and sold throughout Europe by a placement syndicate organized by a London bank and including banks of many European countries. In 1970 Enel issued the first variable-rate Eurobond.

Since July 1999, following the approval of a new law on securitization, gross issues of asset-backed securities by Italian companies have grown rapidly. Most of these transactions have been carried out by banks. Those by public entities have also been very substantial. The securitizations of INPS and INAIL claims for social security contributions, of the proceeds on the sale of publicly-owned real estate and of future lottery receipts constitute around 27 per cent of the total; the bonds have largely been placed in the international market and are generally listed in Luxembourg.

In recent years there has also been significant growth in bond issues by Italian local authorities, whose Eurobond issues amounted to more than €15 billion between 1998 and June 2003. Around 90 per cent of the bonds issued by Italian local authorities are listed in Luxembourg.[11]

Table 4

Bond issues by Italian non-financial companies on the Luxembourg market (1998 - June 2003)

Parent company at time of issue	Parent company at June 2003	EUR millions (1)	Percentage of total
Ing C Olivetti & C SpA/Pirelli/Seat PG	Pirelli and Telecom	44,978	57.2%
Fiat SpA	Fiat	12,600	16.0%
Parmalat SpA	Parmalat	6,192	7.9%
Italenergia SpA	Italenergia	1.895	2.4%
Cofide/L'Espresso	Cofide – Comp. Fin. De Benedetti	1,655	2.1%
Fondiaria SpA	Fondiaria SpA	1,247	1.6%
Cirio/Del Monte	Cirio SpA	1,197	1.5%
Autogrill/EdizioneHolding/Benetton	Benetton Group SpA	1,081	1.4%
Impregilo SpA	Impregilo SpA	1,050	1.3%
Fin Ba SpA	Fin Ba SpA (Barilla)	875	1.1%
Lucchini SpA	Lucchini SpA	600	0.8%
Tiscali SpA	Tiscali SpA	400	0.5%
Italmobiliare SpA	Italmobiliare SpA	350	0.4%
Luxottica Group SpA	Luxottica Group SpA	350	0.4%
Telepiu SpA	Telepiu SpA	350	0.4%
Safilo SpA	Safilo SpA	300	0.4%
Bonaparte SpA	Bonaparte SpA	225	0.3%
Cartiere Burgo	Cartiere Burgo	200	0.3%
IT Holding SpA	IT Holding SpA	200	0.3%
Astaldi SpA	Astaldi	150	0.2%
De Longhi SpA	De Longhi	150	0.2%
Finmek SpA	Finmek	150	0.2%
Merloni Elettrodomestici SpA	Merloni	150	0.2%
Reno De Medici SpA	Reno De Medici	150	0.2%
Frati Group SpA	Gruppo Frati	130	0.2%
Cremonini SpA	Gruppo Cremonini	129	0.2%
Prada Holding NV	Prada Holding NV	129	0.2%
Fantuzzi Reggiane SpA	Fantuzzi	125	0.2%
Autostrada Torino-Milano	ASTM	120	0.2%
Elettra SpA	Elettra SpA	105	0.1%
Inter Auto Parts Italia SpA	Inter Auto Parts Italia SpA	105	0.1%
Amplifon SpA	Amplifon SpA	100	0.1%
Aprilia SpA	Aprilia SpA	100	0.1%
Bulgari SpA	Bulgari SpA	100	0.1%
Carraro SpA	Carraro SpA	100	0.1%
Chiesi Farmaceutici SpA	Chiesi Farmaceutici SpA	100	0.1%
Ducati Motor Holding SpA	Ducati Motor Holding SpA	100	0.1%
Giacomelli Sport Group SpA	Giacomelli Sport Group SpA	100	0.1%
Gianni Versace SpA	Gianni Versace SpA	100	0.1%
Giochi Preziosi Group	Giochi Preziosi Group	100	0.1%
Grandi Navi Veloci SpA	Grandi Navi Veloci - Grimaldi	100	0.1%
I Viaggi Del Ventaglio SpA	I Viaggi Del Ventaglio SpA	100	0.1%
Stefanel SpA	Stefanel SpA	100	0.1%
Merloni Termosanitari SpA	Merloni	77	0.1%
Arena Holding SpA	Arena Holding SpA	35	0.0%
Total		**78,651**	**100.0%**

Source: Dealogic.
(1) Issue amounts.

Table 5

Main Italian public-sector issuers of Eurobonds (1995 - June 2003)

Issuer	Parent company/Originator*	Number of issues	Market of listing	EUR millions (1)	Percentage of total
Societa di Cartolarizzazione dei Crediti INPS - SCCI SpA	Republic of Italy*	6	Luxembourg	9,360	18.1%
Societa di Cartolarizzazione degli Immobili Pubblici Srl	Republic of Italy*	7	Luxembourg	8,937	17.2%
Region of Umbria	Region of Umbria	6	Luxembourg	3,749	7.2%
CPG Societa di Cartolarizzazione 2003	Cassa Depositi e Prestiti *	12	Luxembourg	3,326	6.4%
Societa per la Cartolarizzazione dei Crediti e dei Proventi Prl	Republic of Italy*	3	Luxembourg	3,000	5.8%
ENI SpA	ENI SpA	2	Milan/ Luxembourg	2,000	3.9%
Region of Sicily	Region of Sicily	4	London/ Luxembourg	1,881	3.6%
Region of Marche	Region of Marche	4	Luxembourg	1,512	2.9%
Region of Lazio	Region of Lazio	7	Luxembourg	1,354	2.6%
INAIL - Societa di Cartolarizzazione SpA	Republic of Italy*	1	Luxembourg	1,350	2.6%
Romulus Finance Srl	Aeroporti di Roma Spa*	5	Luxembourg	1,264	2.4%
Poste Italiane SpA	Poste Italiane SpA	3	Luxembourg	1,250	2.4%
Region of Lombardy	Region of Lombardy	1	Luxembourg	1,014	2.0%
ENI Coordination Center SA	ENI Spa	12	Unquoted/ Luxembourg	993	1.9%
Banco di Napoli SpA	Banco di Napoli SpA	3	Luxembourg	900	1.7%
Rossini BV	Region of Sicily*	1	Luxembourg	848	1.6%
Cartesio Srl Series 2003 1	Region of Lazio*	4	Luxembourg	836	1.6%
INA - Istituto Nazionale delle Assicurazioni SpA	INA – Istituto Nazionale delle Assicurazioni SpA	1	Luxembourg	750	1.4%
Alitalia - Linee Aeree Italiane SpA	Alitalia – Linee Aeree Italiane SpA	1	Milan	716	1.4%
Region of Abruzzo	Region of Abruzzo	4	Luxembourg	715	1.4%
Crediti Sanitari Regione Sicilia - Societa per la Cartolarizzazione Srl	Region of Sicily*	1	Luxembourg	655	1.3%
Region of Puglia	Region of Puglia	1	Luxembourg	600	1.2%
Aegis Srl	Republic of Italy (SACE)*	1	Luxembourg	599	1.2%
Optimum Finance BV	Republic of Italy (SACE)*	4	Luxembourg	551	1.1%
Region Autonome of Vallee D'Aoste	Region Autonome of Vallee D'Aoste	2	Luxembourg	543	1.0%
Cartesio Srl Series 2003 2	Republic of Italy*	2	Luxembourg	500	1.0%
Region of Tuscany	Region of Tuscany	1	Luxembourg	465	0.9%
Autonomous Region of Sardinia	Autonomous Region of Sardinia	1	Luxembourg	390	0.8%
Region of Friuli-Venezia Giulia	Region of Friuli-Venezia Giulia	2	Luxembourg	348	0.7%
City of Venice	City of Venice	2	Luxembourg	271	0.5%
Cabco Finance BV	Region of Tuscany*	1	London	232	0.4%
Istituto per lo Sviluppo Economico dell'Italia Meridionale	Banco di Napoli Spa	5	Unquoted/ Luxembourg	202	0.4%
Comune di Milano	Comune di Milano	1	Luxembourg	170	0.3%
City of Rome	City of Rome	1	Luxembourg	133	0.3%
ATAC SpA	ATAC SpA	1	Luxembourg	110	0.2%
City of Florence	City of Florence	3	Luxembourg	88	0.2%
Region of Liguria	Region of Liguria	2	Luxembourg	88	0.2%
ARV International Ltd	Inail – Società di Cartolarizzazione Spa*	2	Luxembourg	50	0.1%
Banco di Napoli SpA (London)	Banco di Napoli SpA	1	Luxembourg	38	0.1%
Province of Naples	Province of Naples	1	London	34	0.1%
Total		**122**		**51,822**	**100.0%**

Source: Dealogic.
(1) Issue amounts.

3. Defaults in the bond markets in the three years 2000-02

Credit risk on corporate bonds has increased significantly in all the leading countries since the spring of 2000 as a result of the prolonged slowdown of the world economy and the consequent deterioration in firms' profitability. Since the second half of 2001 investors' perception of issuers' creditworthiness has been influenced by the destabilizing effects of terrorist attacks and the revelation of serious accounting irregularities at large companies, notably in the United States.

The increase in defaults contributed to the sharp slowdown in bond offerings in 2002 in all the major economies. In the euro area total net issues by banks and firms fell from €437.9 billion in 2001 to €298 billion in 2002, or by 32 per cent; the contraction was large for banks (29 per cent) and non-financial corporations (70 per cent) but small in the case of non-bank financial corporations (3 per cent). In the United States net issues by banks and firms fell from €907 billion to €553 billion, or by 39 per cent. In the international market net offerings by euro-area issuers declined from €590.8 billion to €405.9 billion, or by 31 per cent.

According to Moody's, a worldwide total of 635 issuers rated by the agency defaulted on their bonds in the three years 2000-02 (Figure 3 and Table a8); the defaults concerned almost 1,900 bonds with an aggregate issue value of nearly $340 billion. At constant prices, the average default amount was $1.3 billion in 2001 and 2002, four times that in the period from 1983 to 2000 (Moody's 2003a).

Defaults by private-sector companies approached the levels reached during the recession of the early 1990s. According to Moody's, in January 2002 the ratio of the number of firms defaulting in the previous twelve months to the total number of issuers hit a peak of 3.8 per cent, only a little below the historic high of 4.3 per cent recorded in June 1991 during the previous recession (Figure 4). The cases of default included investment grade bonds but were more frequent for speculative grade paper, the default rate on which rose to 10.8 per cent, compared with 12.8 per cent in June 1991.[12] The default rate is much higher if calculated on the basis of the value of the securities; in November 2002 it reached 23.4 per cent, around 1.7 times higher than the previous peak of July 1991.

Many of the defaults were by companies belonging to the telecommunications sector, which in 2002 accounted for 31.2 per cent of all insolvent issuers, up sharply compared with the past. Summing these with defaults by media and technology firms, in 2002 so-called New Economy companies accounted for 47 per cent of the number of issuers and 75 per cent of the total value in default.

While in the United States bond market the default cycle peaked in January 2002, in the other international bond markets, consisting almost exclusively of the Euromarket, defaults continued to rise for another twelve months. For the European market in high-yield securities, which had been virtually non-existent until the early 1990s, this was the first major crisis of issuer solvency.

In Europe defaults rose to a record value in 2002; 19 per cent of the number of defaults worldwide and 23 per cent of the volume were attributable to European companies, up from 7 and 4.2 per cent respectively in 2001 (Moody's, 2003b). Thirty-two companies were involved (Table 6). The defaults were concentrated in the countries with the most highly developed financial markets; fifteen of the companies were British and eight Dutch, while three defaults occurred in Germany and one each in Italy, France, Belgium, Switzerland, Sweden and Norway. Four of the defaulting companies were unrated (one Italian, one Belgian and two German). The information provided by Moody's also shows that four defaults were by firms whose paper the rating agency had classified as investment grade a year earlier.

The default in Italy involved companies belonging to the Cirio group, which had made nine bond issues totaling €1.125 billion, all of them on the Euromarket;[13] most of the securities (€825 million) fall due between 2004 and 2006. Seven issues amounting to €950 million were made through group subsidiaries headquartered in Luxembourg and the Netherlands. The securities, listed in Luxembourg

Table 6

European companies that defaulted in 2002

	Country of residence	Date of default	Sector of activity	Amount of default (EUR millions)	Unrated security
Netia Holdings B.V.	Netherlands	10 Jan.	Telecommunications	546	
United Pan-Europe Communications N.V.	Netherlands	1 Feb.	Mass media	6,160	
Carrier1 International S.A.	Switzerland	12 Feb.	Telecommunications	281	
Muehl Product & Service AG	Germany	10 Mar.	Industry	117	✓
Energis plc	United Kingdom	14 Mar.	Telecommunications	1,095	
IFCO Systems NV	Netherlands	15 Mar.	Industry	212	
Philipp Holzmann AG	Germany	21 Mar.	Industry	272	✓
Flag Telecom Holdings Ltd.	United Kingdom	30 Mar.	Telecommunications	644	
NTL Communications Corp.	United Kingdom	1 Apr.	Telecommunications	10,179	
Flag Limited	United Kingdom	12 Apr.	Telecommunications	489	
Grapes Communications NV	Netherlands	16 Apr.	Telecommunications	212	
Diamond Cable Communications Limited	United Kingdom	6 May	Telecommunications	1,484	
Diamond Holdings Limited	United Kingdom	6 May	Telecommunications	368	
NTL Incorporated	United Kingdom	6 May	Telecommunications	1,310	
Northern Offshore ASA	Norway	15 May	Energy	422	
KPNQwest N. V.	Netherlands	23 May	Telecommunications	1,702	
Completel Europe NV	France	30 May	Telecommunications	280	
SWT Finance B.V.	Netherlands	3 June	Industry	100	
VersaTel Telecom International N.V.	Netherlands	19 June	Telecommunications	1,586	
Callahan Nordrhein-Westfalen GmbH	Germany	21 July	Mass media	1,970	
Song Networks	Sweden	1 Aug.	Telecommunications	572	
Texon International plc	United Kingdom	1 Aug.	Consumer goods	125	
Marconi Corporation, Plc	United Kingdom	29 Aug.	Telecommunications	3,334	
Telewest Communications plc	United Kingdom	30 Sept.	Mass media	5,264	
Energy Group Overseas B.V. (*)	Netherlands	15 Oct.	Finance	509	
TXU Europe, Ltd. (*)	United Kingdom	15 Oct.	Public services	153	
Jazztel plc	United Kingdom	31 Oct.	Telecommunications	667	
Cirio Finanziaria SpA	Italy	3 Nov.	Consumer goods	175	✓
TXU Eastern Funding Company (*)	United Kingdom	20 Nov.	Public services	2,128	
AES Drax Holdings Limited	United Kingdom	16 Dec.	Public services	610	
Fardis SA	Belgium	31 Dec.	Industry	11	✓
Navigator Gas Transport PLC	United Kingdom	31 Dec.	Industry	290	

Source: Moody's.
(*) Subsidiaries of TXU International, Inc.

and not bearing a rating, carried a higher coupon yield than the securities of non-financial firms with the minimum good rating (ranging from BBB+ to BBB-).

4. Eurobond issues: practices and rules

As mentioned earlier, the participation of the leading international banks in the syndicates organizing international bond issues makes for broad uniformity of issue techniques and placement procedures.

The International Primary Market Association (IPMA) is the principal organization involved in defining placement practices in the Euromarket. Its recommendations, along with specimens of the main contracts drawn up in connection with issue procedures, are contained in a volume known as the IPMA Handbook.[14]

The activity of the syndicates created for the distribution of securities issued in the international market can be performed either by public offering or by private placement with banks and other professional investors. For Eurobond issues, the latter procedure is largely prevalent; among other things it permits faster conclusion of the transaction, enabling the issuer to have the proceeds available with certainty at a predetermined date.

Another important factor in the decision to issue Eurobonds is the listing procedure. According to Banfi and Onado, "Euro-issues are usually listed on the Luxembourg stock exchange, where listing is less costly and time-consuming than on MOT and EuroMOT (where it usually takes several months). A further consideration is that on the Luxembourg exchange Eurobonds are listed the same date they are issued."[15]

The characteristics of a bond issued on the Euromarket are made known to professional investors through the offering circular (or information memorandum). Although the expression "offering circular" may bring public offerings to mind, it is "never a public offer prospectus".[16] According to an established practice, Eurobond issues are initially underwritten by several banks (so-called lead managers or members of the placement syndicate or selling group). The banks then sell the bonds to professional investors, mainly other banks, exclusively on the basis of the offering circular.

The procedures by which securities issued in the Euromarket may be purchased by savers are governed by specific laws and regulations whose provisions differ depending on the country in which savers are resident.

The rules on soliciting investment in securities in Germany, France and the United Kingdom, in particular, have many features in common with those in Italy, not least because they refer to the European Union directive on public offer prospectuses. A public offer of securities other than those destined for stock-exchange listing requires a prospectus; the prospectus is not envisaged for issues that are small or with a high minimum denomination, or if the securities are aimed at sufficiently knowledgeable investors (institutional investors, major shareholders, etc.), or on various conditions, in the case of Eurobonds. Furthermore, in all three countries – as in Italy – the sale of securities to customers is governed by specific rules of conduct for intermediaries.

It is also necessary to distinguish between countries when it comes to the sale on the secondary market of securities sold without a prospectus on the primary market, as in the case of Eurobonds. In France and Germany the prospectus is not required provided the original basis for exemption continues to obtain; otherwise, the entity offering the securities must prepare a prospectus. In France the competent authority (the Commission de Bourse) allows securities without a prospectus to be sold to individual investors if the transaction takes place at the initiative of the investor.[17] In Germany, Eurobonds may be sold without an offer prospectus at the request of the customer, but such occurrences are infrequent; it is customary to prepare a summary description in German.[18] In the United Kingdom, Eurobonds do not require a prospectus and may be resold to the public provided they are not advertised to "inexperienced investors"; in practice, however, Eurobonds are rarely sold to the public, owing in part to the restrictive stance of the competent authority, and must first be held by the institutional investor for at least six months.[19]

5. The rules governing the issue, placement and trading of securities in Italy

5.1 The rules on bond issues

The Civil Code sets specific quantitative limits on bond issues, following an approach adopted in Italy first by the 1865 Code of Commerce, then by the amended Code of 1882 and finally by the Civil Code of 1942.

Under Article 2410 of the Civil Code in the text currently in force, public limited companies may not issue bonds in an amount exceeding their paid-up capital at the date of the resolution to issue bonds, as shown by the latest approved annual accounts; derogation is envisaged for bond issues backed by a specific pledge of real estate or government securities or following a specific decision by a governmental authority. For listed companies, the general ceiling of paid-up capital was raised to the amount of capital and reserves by the Interministerial Committee for Credit and Savings on 3 March 1994 pursuant to Article 11 of the 1993 Consolidated Law on Banking.

The function of these ceilings has been a matter of debate. According to one interpretation, the reason for the rule lies in the need to offer bondholders a generic guarantee consisting in a minimum capital amount, corresponding to existing paid-up capital. However, the reference to existing paid-up capital rather than to balance sheet assets and the possibility that recourse to other forms of borrowing may render the generic guarantee useless suggest that the limits should be considered a means for maintaining the balance between debt capital and equity in the company's financial structure and, in particular, for "preventing undercapitalized companies from financing themselves with large amounts of loan capital raised by issuing mass securities, hence by soliciting public saving".[20]

According to this second interpretation, the guarantee function performed by the ceilings is only indirect and consists in the greater likelihood that a balanced relationship among all forms of financing (equity capital, direct recourse to the debt capital market, bank credit) will render the company solvent in the longer run.

With the entry into force on 1 January 2004 of the new "company law" (the relevant articles of the Civil Code as amended by Legislative Decree 6/2003), public limited companies will be able to issue bonds up to an amount equal to twice their capital and reserves (share capital, legal reserve and available reserves shown by the latest annual accounts; Article 2412, first paragraph). Bonds issued in excess of such limit may be subscribed for by professional investors subject to prudential supervision; in the event that they subsequently sell such bonds to buyers other than professional investors, the original subscribers are liable for the solvency of the issuer up to the amount sold (Article 2412, second paragraph).

No limit is set on bond issues by companies whose shares are listed on regulated markets, where the bonds are also to be listed on regulated markets (Article 2412, fourth paragraph). In addition, derogation is still provided for where the bonds are secured by real estate (Article 2412, third paragraph) or where a governmental authority has approved an exemption (Article 2412, fifth paragraph).

In setting a general limit accompanied by a series of derogations, the new provisions follow an approach of continuity with the past. At the same time, they grant companies greater scope for direct recourse to debt capital markets, taking account of the growth of these markets abroad as well as in Italy and their increased ability to marginalize excessively risky phenomena.[21]

Both under the rules now in force and in those introduced with the reform, the quantitative limit refers to each individual issuer. According to this "atomistic" approach, constantly followed by the supervisory authorities and validated by court decisions, even when a company belongs to a corporate group the limit refers to its own funds and not to those of the group as a whole.

5.2 Issues of securities and Article 129 of the Consolidated Law on Banking

Article 129 of the Consolidated Law on Banking establishes that issues of securities and offers in Italy of foreign securities are to be notified in advance to the Bank of Italy, which, for the purpose of ensuring the stability and efficiency of the market, may prohibit the operation or defer its execution within twenty days of receipt of the notice.

The notification requirement does not apply to: a) issues smaller than €150 million in the case of securities listed or to be listed on a regulated market and having the standard characteristics specified by the Bank of Italy; b) issues smaller than €50 million in the case of unlisted securities having the standard characteristics specified by the Bank of Italy; and c) issues of shares, government securities or investment fund units.

Notification is required even when the offer of securities is aimed exclusively at professional investors. The controls provided for by Article 129 of the Consolidated Law on Banking do not involve economic evaluations of the merit of investment in the securities offered or the degree of solvency of the issuer.

The rules implementing Article 129 are contained in a resolution adopted by the Credit Committee on 12 January 1994[22] and the Supervisory Instructions issued by the Bank of Italy in June of the same year. They lay down that the power to prohibit or defer the operations is to be exercised only where:

– the amount of the issue is incompatible with the size or conditions of the market (for example, with its degree of liquidity);
– the securities offered do not conform with the regulations in force or with standards of comprehensibility, or their parameters of indexation do not correspond to standards of objectivity;
– in the case of foreign securities, it is not possible to ascertain the existence in the issuer's home country of rules and controls similar to those established by Italian law.

Article 129 of the Consolidated Law on Banking is the result of a reformulation, undertaken in 1993 and amended in 1996, of previous provisions regarding controls on securities.[23] These had been juxtaposed one upon another over time and were distinguished by a diversity of objectives and non-uniform assignment of administrative competence and procedures, which were based on the authorization model.[24]

The Consolidated Law on Banking reinterpreted the function of controls on issues of securities in the light of the liberalization of capital movements, which was completely implemented in Italy by 1988, and full acceptance of competition in the financial markets. In 1993 Parliament eliminated the uncertainties about the purposes of controls, reducing them, in an expression lifted from Law 281/1985, to the protection of the stability of the market in private debt securities and assigning controls exclusively to the Bank of Italy. The authorization system was replaced by a prior notification procedure based on tacit approval.

The result excludes any and every possibility of public intervention aimed at setting the level of interest rates or creating discriminatory conditions for foreign entities or private issuers so as to ensure the financing of the public debt.

The question of the individual issuer's solvency remains extraneous, being absorbed in the definition of the prudential requirements for banks and, for other issuers, in the regulations on the raising of repayable funds by non-banks established by specific laws and by the Civil Code.

Article 129 of the Banking Law and its implementing provisions unequivocally calibrate the prior controls on the placement of securities in Italy, limiting them to support for the qualitative standards of the debt capital market and to evaluation of the quantitative impact of issues, to prevent an overcrowding of issues from disturbing the market's stability, in the sense of its short-term equilibrium.[25]

5.3 The provisions of the Consolidated Law on Finance regarding public offerings, the placement and trading of financial instruments

A first set of rules established by law to ensure adequate information of investors in financial instruments concerns *public offerings*, which the 1998 Consolidated Law on Finance defines as "every offer, invitation to offer or promotional message, in whatsoever form addressed to the public, whose objective is the sale or subscription of financial products" (Article 1.1t). The notion of public offering therefore includes activities intended to promote investment in financial products, i.e. to encourage the public to purchase or subscribe for such products.

The rules governing *public offerings* are contained in Article 94 et seq. of the Consolidated Law on Finance and in Consob Regulation 11971/1999 implementing these. For issuers, offerors and placers, they establish a series of requirements regarding public information – first and foremost, the publication of a prospectus supervised by Consob (Article 94) – and proper conduct both before and during the offering. These rules do not apply to certain cases provided for by Article 100, including offerings aimed exclusively at professional investors (Article 100.1a) and those having as their object financial products issued by banks, other than shares, or insurance products (Article 100.1f).

Then there are the rules governing *investment services,* contained in the Consolidated Law on Finance and Consob Regulation 11522/1998, establishing the correctness and transparency requirements for authorized intermediaries. Among the investment services defined by Article 1.5 of the Consolidated Law on Finance, of particular interest here are those of placement and trading (for own or for customer account).

Placement consists in own-account selling of securities that the intermediary has underwritten or in selling securities or offering them for subscription on behalf of the issuer or owner. Where a placement is accompanied by a public offering, the rules on the prospectus apply and a prospectus must be delivered to the investor upon request (Article 13.1 of Consob Regulation 11971/1999).

Trading[26] is likewise subject to the general rules governing the provision of investment services, which establish specific rules of conduct. As in the case of placement, Consob requires that: 1) customers must be adequately informed about the transactions carried out; 2) intermediaries must assure customers of the necessary transparency by reducing situations involving conflicts of interest to a minimum;[27] and 3) investors must be advised against carrying out unsuitable transactions.

On a general plane a placement exists only when there is an offering of financial instruments at standardized conditions aimed at the general public or at some categories of investors, but in any case in the context of an operation aimed at a multitude of anonymous persons. By contrast, in the case of trading for own account the search for a counterparty takes place in connection with a specific transaction involving a given quantity of financial instruments, and investments are made through a succession of individual transactions that are not necessarily identical in terms of price and quantity.

Finally, account should be taken of the fact that dealing for own account in financial instruments could also be carried out on alternative trading systems, which are governed by Article 78 et seq. of the Consolidated Law on Finance. Consob defines an alternative trading system as "a set of rules and structures, automated or otherwise, that make it possible on a continuous or periodic basis to: a) gather and disseminate orders for trades in financial instruments, b) execute such orders with the procedures provided for by the system" (Article 2, Consob Communication No. DM98097747 of 24 December 1998).[28]

Regarding the possible sale of Eurobonds to private investors, in Italy the absence of the prospectus envisaged for public offerings prevents banks – both those that initially subscribe for the securities and those that acquire them from the ones placing the securities – from soliciting the public to buy them. However, banks may sell the securities they own to customers at the latter's request, as part of their proprietary trading.

The sequence "firm commitment underwriting – trading in the secondary market" does not imply violation of the prospectus requirement. In this matter, for some time now Consob has formulated criteria for the interpretation of circumstantial evidence permitting identification of violations of such requirement; sale at very short intervals, at standardized conditions and uniform prices, is considered circumstantial evidence in this sense. The permissibility of the sale of securities on the secondary market, even during the so-called grey market, is not called into question, nor is the possibility for intermediaries to engage in somehow "propositional" activities, unless the case involves violation of the rules on public offerings.[29]

The so-called grey market, which runs from the announcement of an issue (launch day) to the date the issue is settled and the proceeds are paid to the issuer (closing day), generally lasts from two to four weeks. It can embrace both initial subscription for the securities by professional investors, who purchase them from the banks participating in the placement syndicate, and trading of these securities with customers upon request.[30]

The issue and placement of bonds of the companies belonging to the Cirio group followed the procedures described earlier and adopted for most of the international bond issues by Italian groups in recent years.

Issued on the Euromarket, the Cirio bonds were initially underwritten on a firm commitment basis by several banks, which subsequently sold them to institutional investors and private parties, similarly to what happened for the other main international issues by Italian groups.

In general, analysis of the placement procedures for Eurobonds shows that at the close of the placement the banks participating in syndicates generally hold modest percentages of the bonds, and that these percentages are destined to fall further in the subsequent months. Moreover, the quantity of securities held by the other banks – those that buy them as institutional investors from the syndicate banks – also tends to decrease significantly following the close of the placement. This behaviour on the part of the banks is consistent with the prevailing role they play in the bond market, directed towards supplying the necessary services to assist the exchange of funds between issuers and purchasers.

5.4 Controls

Controls on violations of the rules on public offerings and controls on compliance by intermediaries with the rules of conduct in transactions involving financial instruments come under Consob's jurisdiction. However, the public interest in the correct conduct and integrity of intermediaries also impinges on the tasks of supervising financial stability and risk limitation that are entrusted to the Bank of Italy, which cooperates with Consob in every way.

Irregularities committed by intermediaries in the public offering, placement and trading of securities are discovered by Consob ex post, in part through on-site inspections by means of which Consob traces the paths taken by the securities, from the time they were issued to the time they were acquired by customers.

Inspections at intermediaries are conducted directly by Consob or, at the latter's request, by the Bank of Italy pursuant to Article 10 of the Consolidated Law on Finance.[31]

As a consequence of inspections, which are performed at the administrative level of public supervisory controls, pecuniary sanctions may be imposed (Articles 190 and 191 of the Consolidated Law on Finance). Findings of serious violations of the rules, reflecting management irregularities, are followed by disciplinary measures and reported to the judicial authorities.

6. Conclusion

The development of the corporate bond market, which has occurred in all the European countries in recent years, provides an important contribution to the strengthening and growth of the economy. It amplifies the possibilities of financing for firms and the available choices for the use of savings; it fosters a more efficient allocation of resources.

Greater recourse to sources of direct financing, and particularly to medium and long-term bond debt, permits better balance in the financial structure and facilitates the realization of investment projects and the expansion of firms.

In Italy, a fragmented productive system characterized by a multitude of small firms stands only to benefit from the development of a large and efficient bond market.

The launch of the single currency has imparted a strong impetus to the growth of the capital market in the countries of the euro area. The creation of a single money and financial market before full harmonization of the tax treatment and issue rules of the member countries has tended to concentrate issues in the markets where taxation and regulatory compliance are less onerous. Those markets are located mainly in small economies. Once the securities are issued, they tend largely to flow back to the countries in which the groups to which the individual issuers belong are established.

The activity of international banks helps to disseminate homogeneous bond placement techniques and practices across all the markets and to establish suitable issue conditions in relation to the risks of each issuer. Although not yet entirely harmonized, the procedures through which the securities issued in the international market can be purchased by private investors in the European countries have various features in common. The EU directives now being drafted regarding the securities markets will help to raise the level of harmonization further, with significant benefits for the expansion of the European single market in securities.

In the euro area, bond issues have grown from 44 to 59 per cent of gross domestic product since the launch of the euro; in Italy they have increased from 28 to 47 per cent of GDP.

The weakness of the international economic cycle has led to a rise in defaults. In 2002 thirty-two European companies were unable to meet their obligations. The defaults were concentrated in the countries where the financial markets are most developed; one case occurred in Italy.

The placement of securities must be based increasingly on ample prior disclosure of information on the assets and liabilities, profits and losses and financial position of the issuer.

Greater recourse to ratings assigned by the leading rating agencies can facilitate evaluation of the creditworthiness of borrowers.

It is essential that the placement of new issues and the trading of the securities on the secondary market by intermediaries take place in fully transparent and correct conditions, according to the rules of conduct established by the competent authorities.

In dealings with savers, transactions that are unsuited to the characteristics of customers must be clearly evidenced. The financial instruments distributed or traded must be consistent with the individual investors' financial needs, economic resources and propensity for risk.

It must be constantly recalled that high yields necessarily entail high risks.

Guarantees of repayment of the amounts invested regard bank deposits only.

Examinations and checks in the form of inspections with a view to clarifying the vicissitudes of the securities issued by an Italian industrial group are now at an advanced stage.

The confidence of investors, the good name of the intermediaries responsible for placement and trading, and completeness of disclosure by issuers are fundamental for the Italian financial market to grow and develop in a balanced and sustained manner.

Judgements not based on ascertained facts and improper generalizations that can hinder the orderly operation of the markets and fuel widespread expectations of intervention in case of losses do not benefit the protection of savings.

[1] A first study of this market was published in the Bank of Italy's Economic Bulletin, No. 30, March 2000, in the box "The euro-area bond market".

[2] The problem of the Italian bond market's underdevelopment is addressed by the new provisions on corporate bonds contained in the new body of company law, which is to enter into force on 1 January 2004. The new rules on bond issues significantly widen the opportunities for direct access to the market by public limited companies.

[3] The Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) operate in the bond market as both buyers and issuers.

[4] However, there is a second-order effect deriving from the fact that bank bonds are not covered by deposit insurance and are therefore riskier for savers than normal bank deposits (which is one reason they offer a higher yield). To some extent, therefore, risk has been transferred from deposit insurance to savers.

[5] See Fischer (1997, p. xii).

[6] See Fischer (1997).

[7] The birth of the Euromarket dates back to 1963, when the introduction of the so-called Interest Equalization Tax in the United States discouraged issues in the US market by non-residents.

[8] The data come from Dealogic. The companies were identified on the basis of the country of residence of the company controlling them. "Italian firms" are therefore both companies having their registered office in Italy and foreign firms belonging to groups having their registered office in Italy. Public utilities and public-sector companies are excluded from the study.

[9] The average size of Italian issues without a rating was €230 million, compared with €270 million for French issues and €320 million for German issues.

[10] Considering only the four major euro-area countries (Germany, France, Italy and Spain), the share of bonds issued by Italian groups is 25.6 per cent.

[11] Most of the bonds issued by Italian local authorities have long maturities. More than 50 per cent of those issued since 1998 will reach maturity between 2011 and 2020 and some 24 per cent the decade following. The ten largest issuers account for more than 90 per cent of the total.

[12] During the Great Depression the default rate on speculative grade paper reached an historic high of 16.3 per cent in December 1933 (Moody's 2003a).

[13] In two cases it was a question of the reopening of a previous issue.

[14] For a brief description of the IPMA's history and activity, see Fisher (1997, p. 84).

[15] Banfi and Onado (2002, p. 100). On the question of listing costs, Fisher (1997, p. 122) shows that in some cases listing in Luxembourg can cost half what it costs on the London Stock Exchange.

[16] Banfi and Onado, 2002, p. 127. However, the fact that a Eurobond placement is aimed at professional investors "obviously does not exclude that the instruments issued, following direct trades between the financial institutions acting as initial subscribers and their customers, may frequently attain very significant levels of final distribution among savers (the so-called retail market)" (ibid.).

[17] In France the issue or sale of financial instruments to the public constitutes fund-raising from the public and the Code Monétaire et Financier therefore requires that a prospectus be prepared. By contrast, the sale of financial instruments to qualified investors (investisseurs qualifiés) does not constitute fund-raising from the public provided such investors act for own account. Where the securities are subsequently to be sold to retail investors on the secondary market, a prospectus must be prepared by the entity (bank or other institutional investor) that will distribute them to the public. In the case of Eurobonds, this obligation can be fulfilled with a summary version in French of the prospectus filed in the security's home country, submitted in advance to the Commission de Bourse. In practice, however, the Commission de Bourse permits retail selling of securities lacking a prospectus provided that the trade is initiated at the request of the investor (so-called reverse inquiry).

[18] Public offerings in Germany have two constituent elements: 1) they are widely advertised, and 2) the investor has the concrete possibility to submit a purchase order that is binding on the offeror. The simple issuance and quotation of securities in the market, without advertising, does not constitute a "public offering". According to the Wertpapier-Verkaufsprospektgesetz of 1990 as amended, a prospectus for the sale of securities outside the stock exchange is obligatory and the responsibility for drawing it up falls on the entity offering the securities in Germany, even when it is not the issuer. A prospectus is not required if the securities are offered, inter alia, to persons that "buy or sell securities on a professional or commercial basis for own or customer account". Euro-securities as defined by Directive 89/298/EC are exempt from the prospectus requirement. The exemption will continue to be recognized in the case of a subsequent sale only if the legal conditions on which it was granted still obtain. In Germany, Eurobonds are resold without a prospectus to customers. However, such transactions in the secondary market are infrequent and for the protection of buyers it is customary, under the provisions of civil law, to prepare a summary information document in German on the characteristics of the security.

[19] In the UK public offers of securities other than those to be listed on the London Stock Exchange are governed by the Public Offers of Securities Regulation of 1995. A public offer is defined as one made to any section of the public, including holders of the company's securities and the company's clients. The law provides for numerous cases which constitute a private placement rather than a public offer; for example, issues reserved to professional investors and issues of Euro-securities are exempt from the prospectus requirement, provided they are not advertised to inexperienced investors. In particular, Euro-securities are defined as securities offered by financial institutions in a country other than that of issue through a syndicate including members of at least two countries. Following a private placement securities admitted to listing on a foreign stock exchange may be offered to the public accompanied only by the listing prospectus required by such stock exchange, but this rarely happens, owing to the restrictive approach of the authority, and then, in practice,

only after the institutional investor has held the securities for at least six months.

[20] Campobasso, 1988, p. 397.

[21] The reform appears to be based on the theory that setting quantitative limits on bond issues is justified by the need to ensure balance among the sources of corporate financing. According to the Report on the reform decree (published in Rivista delle Società, 1, 2003, pp. 112-181), " … the thesis is widely accepted today that the scope of the limit is to realize a balanced distribution of the risk of business activity between shareholders and bondholders. In other words, it is a technique aimed at preventing the shareholders from having recourse to the medium/long-term credit market to an extent that is excessive by comparison with the amount they risk themselves … ".

[22] Comitato interministeriale per il credito e il risparmio, Deliberazione del 12 gennaio 1994, Determinazione dei criteri per l'esercizio dei poteri di controllo sull'emissione e l'offerta di valori mobiliari.

[23] The legislative framework consisted of Articles 2, 44 and 45 of the 1936 Banking Law, Article 21 of Law 281/1985, which replaced Law 428/1955, and Article 11 of Law 77/1983.

[24] Among the purposes of the provisions predating the new Consolidated Law on Banking, which were not always clearly indicated, an important role was played by the systemic objective of regulating financial flows and safeguarding the functioning of the financial market as a whole. For example, the Report accompanying the bill that would become Law 428/1955 specified that a goal was to "prevent an accentuated recourse to savings in a short span of time from having a negative influence on the cost of the individual transactions as well as harming the regular performance of the financial markets". Subsequently, Law 77/1983 (Article 11.1) established that the powers to reduce issues were assigned to the Bank of Italy "for the sole purposes of control of financial flows", and Law 281/1985 (Article 21.1) mentioned the aim of "ensuring the stability of the securities market".

[25] The amendments of 1996 strengthened this approach by making the efficiency of the market, as well as its stability, a value to be protected, introducing the threshold issue amounts below which quantitative controls are irrelevant and promoting the systematic gathering of data on all securities actually placed, including those not notified in advance.

[26] Trading consists in buying and selling financial instruments on the market on behalf of the investor (dealing for customer account) or as the latter's direct counterparty (dealing for own account).

[27] Article 27.2 of Consob Regulation 11522/1998 establishes the following concerning conflicts of interest: "Authorized intermediaries may not carry out transactions with or on behalf of their clients where they have directly or indirectly a conflicting interest, including any such interest arising from intragroup dealings, the joint provision of more than one service or other business dealings of their own or of group companies, unless they have previously informed the investor in writing of the nature and extent of their interest in the transaction and the investor has expressly agreed in writing to the carrying out thereof."

[28] The rules on alternative trading systems provide that the existence and operation of such systems be notified to Consob and lay down trading transparency standards (Articles 3, 4 and 5 of the above-mentioned Consob communication). On the other hand, Article 205 of the Consolidated Law on Finance establishes that "offers to buy or sell financial products in regulated markets or in organized trading … by persons admitted to trading therein shall not constitute public offerings …", with the consequence that in such cases a prospectus need not be published. The latter rule is in the nature of a derogation, in that the offers formulated in an organized trading system could, were the conditions fulfilled, fall under the broad notion of public offering (which as defined by the Consolidated Law on Finance includes any type of offer or promotional activity addressed to the public for the sale or purchase of a financial product). Parliament considered it necessary to expressly rule out the possibility that under certain conditions such systems might constitute a public offering (Article 205), thereby removing them from the scope of the provisions governing public offerings. However, it must be borne in mind that to qualify for the exemption granted by Article 205 the offer must be formulated by "persons admitted to trading" in an alternative trading system. Legal scholars have argued that on the basis of this requirement the exemption applies exclusively "to alternative trading systems … whose organizational rules provide for a true act of admission" (C. Motti, "Art. 205", in G. Alpa and F. Capriglione, Commentario al Testo unico delle disposizioni in materia di intermediazione finanziaria, 1998, p. 1838). This implies the "necessary third-party nature of the operator's relationship with market participants eligible to formulate offers, since an act of admission is not conceivable where the trading system is set up to serve a single participant, i.e. set up by that participant or at any rate in its interest" (ibid.). This conclusion is supported, on the economic plane, by the argument that greater investor protection is needed in a system lacking in "price significance" (which necessitates many competing potential offerors).

[29] Such activities include, for example, entering securities in special lists of those that intermediaries intend to trade with customers, with an indication of the buying or selling prices.

[30] Banfi and Onado (2002) argue that "the grey market … has brought an appreciable increase in the competitiveness of new issues" (p. 139). Before grey market trading became possible, "trades were made at the official valuation price determined by the lead manager, who thus did not run any risk of undesired price fluctuations. In the grey market trades are essentially made by the brokers on their respective Reuters pages, while the lead manger is the principal price make r. However, since the other members of the syndicate, belonging to the managing group or underwriter, may also handle their own position on the grey market, the lead manager is subject to price risk" (p. 140), hence the greater competitiveness of issues already traded during the grey market.

[31] Regarding the Cirio affair, in April 2003 Consob asked the Bank of Italy to take complete responsibility for the inspections already under way at some of the major distributors of Cirio bonds. Other intermediaries were inspected directly by Consob.

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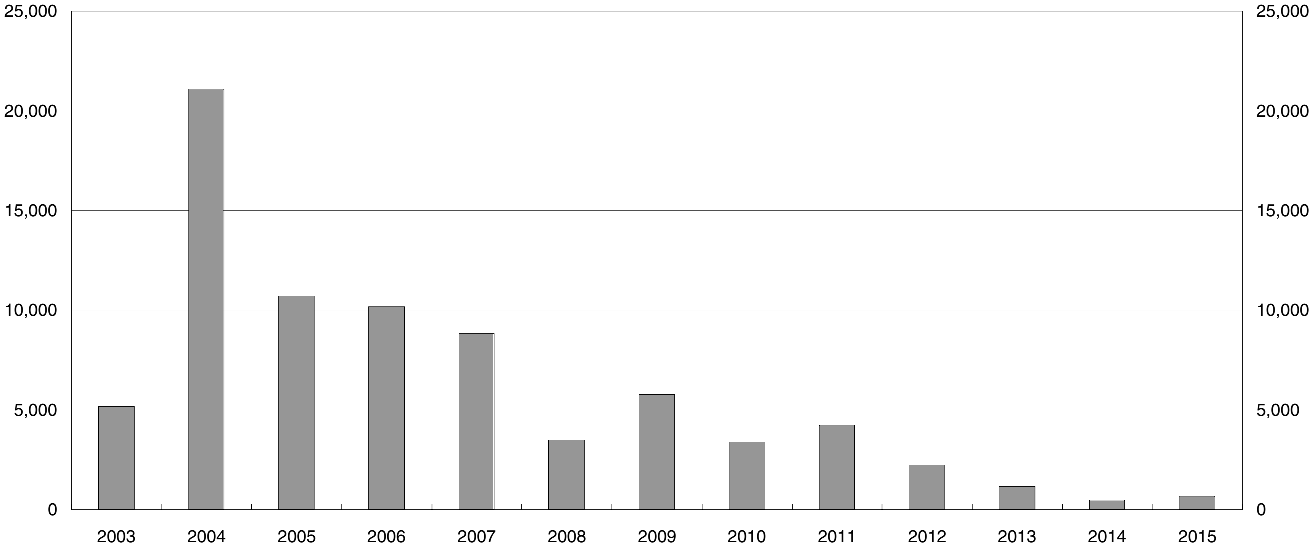
FIGURES AND TABLES

Figure 1

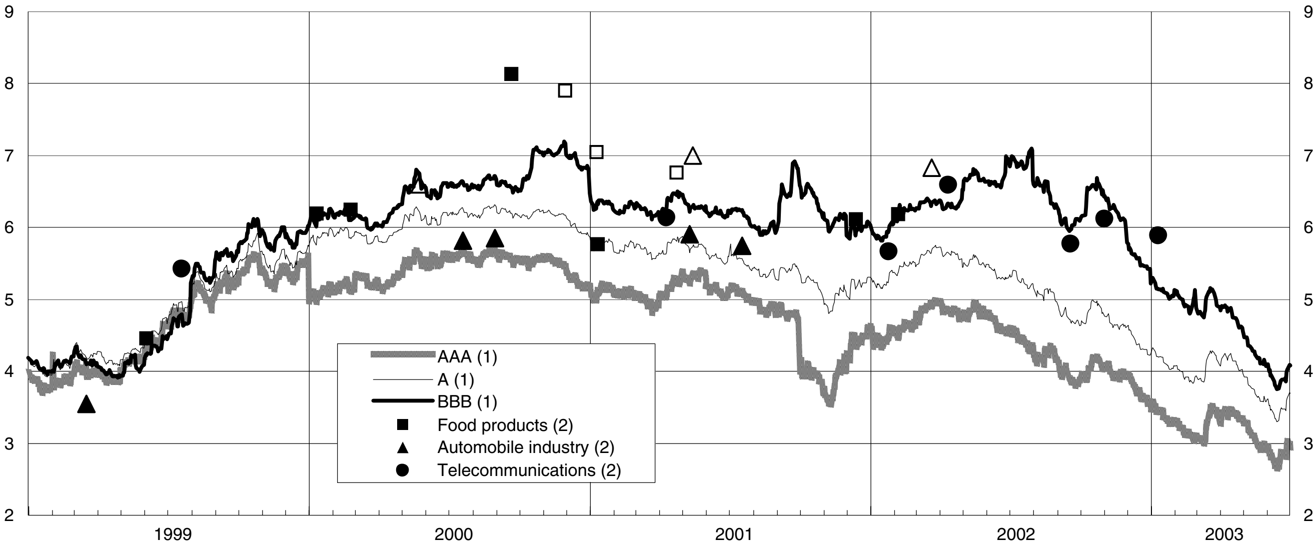
Redemptions of Italian corporate bonds (1)
(millions of euros)



Source: Based on Dealogic data.
(1) Redemptions of bonds issued between January 1995 and June 2003. Issuers' nationality is taken to be that of the parent company. Public-sector companies are excluded.

Figure 2

Eurobond yields at issue: Italian securities and market indices
(daily data; percentages)

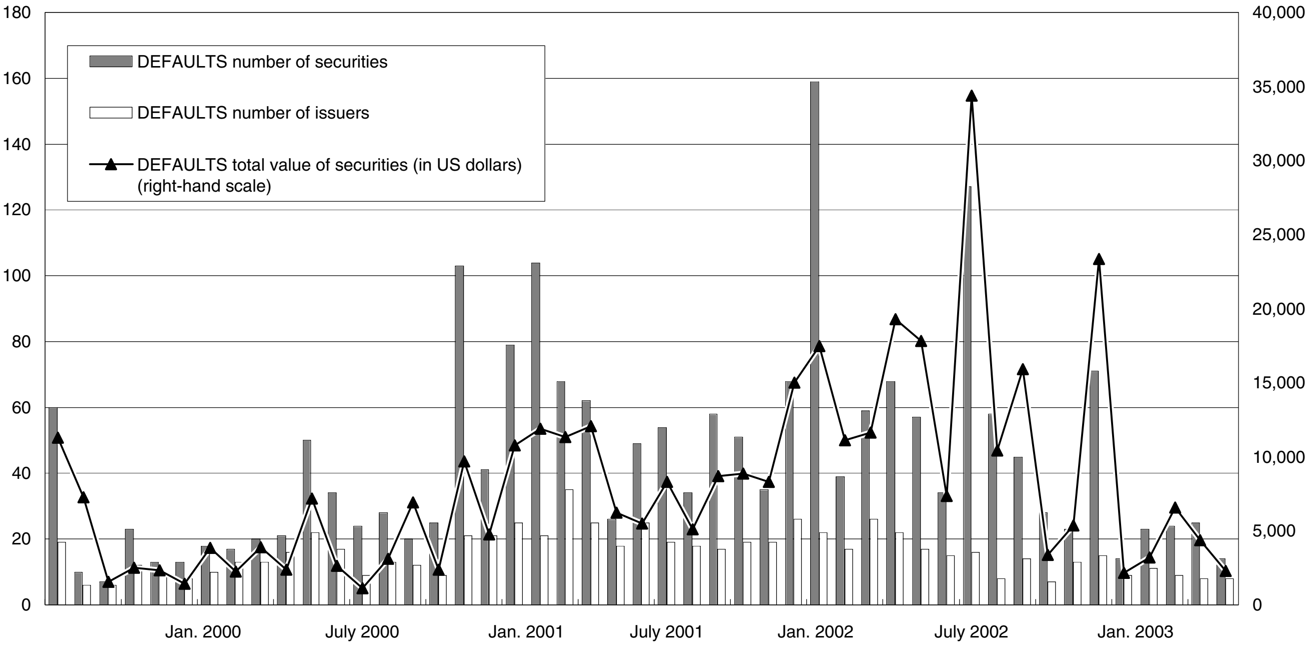


Sources: Based on Dealogic and Merrill Lynch data.
(1) Market index calculated by Merrill Lynch. Each index includes only euro-denominated fixed-rate securities with the rating indicated issued in the Euromarket by non-financial corporations. The average duration of the indexes varies during the period from six and four years. – (2) Italian euro-denominated fixed-rate securities with a regular structure, a duration at issue of 5 years and issued by a company in the sector indicated. The securities that were rated at issue by at least one of the three main rating agencies (Standard & Poor's, Moody's and FitchIBCA) are shown with the symbol printed in black, those without a rating with the symbol printed in outline.

Figure 3

Defaults since mid-1999

(monthly data; number and millions of dollars)

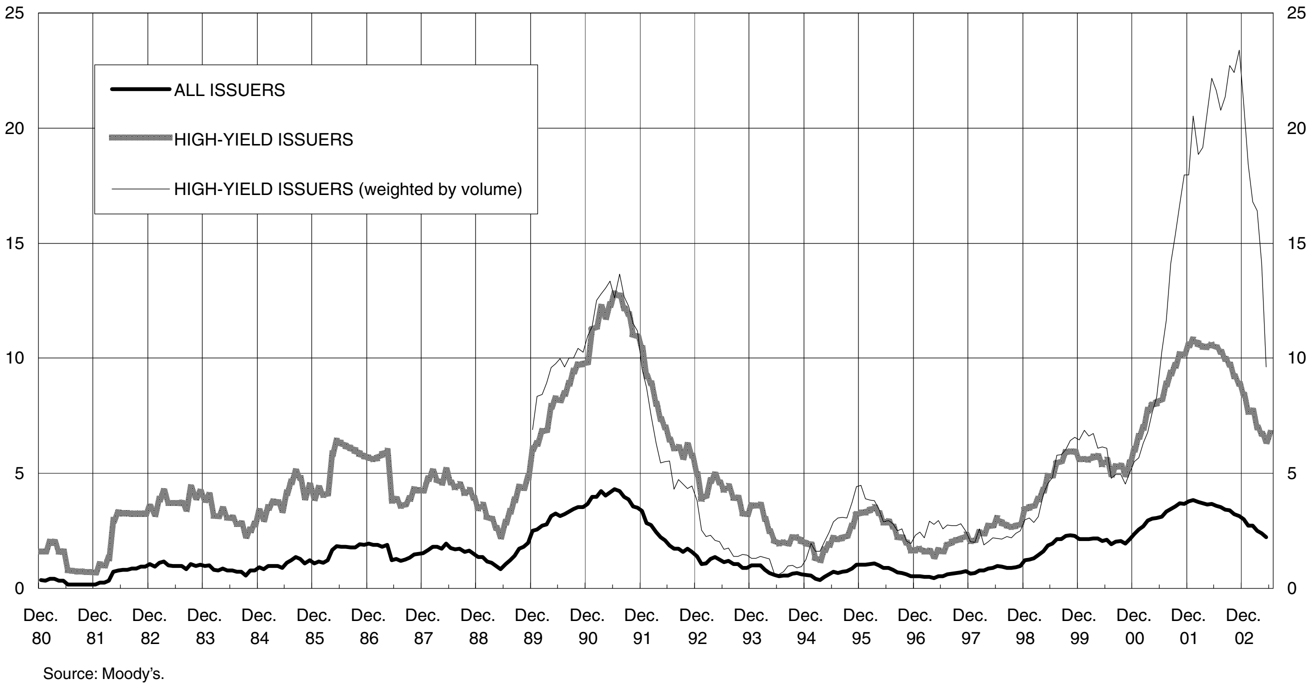


Source: Moody's.

Figure 4

Default rates on world bond markets

(monthly data; percentages)



Source: Moody's.

Table a1

Composition of firms' financial liabilities

	Year	Bonds	Loans	Shares (1)	Other (2)	*Memorandum items:* Financial liabilities	Financial assets
		(percentage shares of total value)				(percentage ratios to GDP)	
France	1995	5.8	27.9	47.2	19.1	2.17	1.32
	2000	4.4	16.1	69.8	9.7	3.99	2.35
	2001	5.8	19.1	64.1	10.9	3.48	2.18
Germany	1995	2.9	42.2	41.3	13.6	1.07	0.61
	2000	1.5	37.3	49.0	12.1	1.68	1.04
	2001	1.9	40.0	45.9	12.3	1.62	1.04
Japan (3)	1995	9.0	39.6	29.8	21.6	3.09	1.62
	2000	9.7	37.6	32.5	20.2	2.65	1.43
	2001	9.9	38.7	31.1	20.3	2.48	1.41
Italy	1995	1.7	39.5	36.1	22.7	1.32	0.65
	2000	1.1	29.7	54.5	14.7	1.90	1.03
	2001	1.8	30.5	52.0	15.7	1.86	1.14
United Kingdom	1995	6.3	23.0	62.4	8.3	2.10	0.76
	2000	7.8	22.2	65.2	4.8	2.98	1.27
	2001	8.8	26.4	59.7	5.2	2.77	1.34
United States (4)	1995	13.2	10.0	51.6	25.2	1.68	0.67
	2000	11.9	8.6	56.9	22.5	2.26	0.94
	2001	14.0	9.2	51.7	25.2	2.07	0.95
Euro4 (5)	1995	3.9	34.1	42.8	19.2	1.49	0.85
	2000	2.7	24.7	59.7	12.9	2.49	1.48
	2001	3.4	27.4	55.2	14.0	2.33	1.47

Source: Eurostat, except where specified otherwise in the notes below.
(1) Shares include other equity. – (2) Foreign trade payables, technical reserves of insurance companies and pension funds. – (3) Bank of Japan, *Flow of Funds Accounts*. The data refer to the fiscal year. – (4) The data refer to non-financial corporations. Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States 1995-2002*. – (5) France,

Table a2

Medium and long-term bonds of Italian, euro-area and US companies (1)

	Net issues (2)					Outstanding amounts						
	Value in billions of euros					Value in billions of euros					As a % of GDP	
	1998	1999	2000	2001	2002	1998	1999	2000	2001	2002	1998	2002
Italy												
Banks	48.2	21.0	36.1	46.1	32.7	265.9	288.2	324.3	370.4	402.3	25	32
Other financial corporations	0.1	11.5	16.3	35.2	26.1	2.0	13.6	29.7	65.1	90.9	0	7
Non-financial corporations (3)	-0.4	25.5	7.6	27.0	5.7	28.4	54.1	61.7	88.1	93.0	3	7
Total	47.9	58.0	59.9	108.3	64.5	296.3	355.9	415.8	523.6	586.2	28	47
of which: international market (4)	*8.2*	*47.9*	*49.4*	*75.6*	*35.1*	*39.7*	*89.4*	*138.9*	*213.0*	*248.2*	*4*	*20*
Memorandum item: public sector	33.0	30.7	36.2	21.3	8.8	939.5	977.3	1,015.0	1,037.5	1,038.5	88	83
Euro area												
Banks	146.1	216.1	239.2	225.6	159.3	2,176.7	2.432.9	2,689.5	2,929.2	3,047.3	36	43
Other financial corporations	26.1	91.1	102.9	112.8	109.1	169.7	267.1	362.2	477.6	566.5	3	8
Non-financial corporations	13.0	54.2	92.1	99.5	29.6	273.4	330.4	421.8	524.9	536.0	5	8
Total	185.2	361.3	434.1	437.9	298.0	2,619.8	3,030.4	3,473.5	3,931.7	4,149.8	44	59
of which: international market (4)	*173.8*	*396.5*	*467.2*	*590.8*	*405.9*	*931.3*	*1,398.7*	*1,869.5*	*2,460.5*	*2,808.0*	*16*	*40*
Memorandum item: public sector	183.3	179.6	123.0	97.5	136.2	3,053.3	3,257.2	3,379.1	3,478.3	3,601.4	51	51
United States												
Banks	8.4	7.4	70.1	83.8	38.6	141.3	170.6	247.6	339.0	333.9	2	3
Other financial corporations	743.4	791.9	718.2	1,118.6	957.3	4,487.3	6,078.0	7,198.4	8,693.7	8,286.3	60	83
of which: government agencies	*421.3*	*566.5*	*463.0*	*712.2*	*575.8*	*2,827.6*	*3,902.8*	*4,627.5*	*5,582.8*	*5,271.6*	*38*	*53*
Non-financial corporations	234.9	228.0	168.4	416.7	133.3	1,849.8	2,398.6	2,720.1	3,272.9	2,926.0	25	29
Total	986.7	1.027.3	956.7	1,619.1	1,129.2	6,478.5	8,647.2	10,166.1	12,305.6	11,546.2	87	116
of which: international market (4)	*306.5*	*473.7*	*414.4*	*548.0*	*336.0*	*939.0*	*1,243.3*	*1,565.2*	*2,021.2*	*2,806.3*	*9*	*26*
Memorandum item: public sector	3.1	-79.5	-194.9	-61.8	260.2	4396.1	3,676.1	3,247.2	3,017.2	3,836.4	43	35

Sources: ECB, BIS and Bank of Italy.

(1) The data are partially estimated. The securities are valued at par. Issuers' nationality and sector are taken to be those of the parent company. The division of securities by sector is based on the classifications used by the ECB and the BIS, which are not homogeneous. – (2) Difference between the par values of the securities issued and redeemed. – (3) The figure for Italy includes the issues made by the State Railways. – (4) For the definition of the international market, see Section 2.2 in the text.

Table a3

Gross issues of Eurobonds by non-financial corporations of the leading euro-area countries (1)
(millions of euros and percentages)

	1995	1996	1997	1998	1999	2000	2001	2002	2003 H1 (2)
					Italy				
Number of issues	5	4	15	20	36	45	44	46	7
of which: rated	*0*	*1*	*2*	*8*	*24*	*28*	*19*	*18*	*6*
Value of issues	213	463	1,899	4,056	24,194	12,142	24,835	13,700	4,300
of which: rated	*0*	*110*	*516*	*2,352*	*21,292*	*9,042*	*13,530*	*8,332*	*4,000*
share of area total	*6*	*5*	*14*	*16*	*25*	*10*	*17*	*12*	*6*
					France				
Number of issues	7	8	23	19	79	113	106	96	74
of which: rated	*3*	*6*	*10*	*11*	*47*	*94*	*75*	*63*	*62*
Value of issues	707	1,490	3,691	3,420	28,231	25,151	33,430	28,841	25,514
of which: rated	*406*	*1,363*	*1,720*	*2,384*	*16,721*	*19,950*	*21,337*	*15,649*	*21,072*
share of area total	*21*	*17*	*28*	*14*	*30*	*20*	*23*	*26*	*34*
					Germany				
Number of issues	13	28	36	48	97	131	142	146	80
of which: rated	*3*	*8*	*16*	*28*	*67*	*120*	*130*	*134*	*71*
Value of issues	895	4,128	4,369	7,626	18,497	45,783	54,769	51,903	33,935
of which: rated	*255*	*1,190*	*2,750*	*4,710*	*14,419*	*41,202*	*46,957*	*43,390*	*27,804*
share of area total	*27*	*46*	*33*	*30*	*19*	*37*	*38*	*47*	*45*

Source: Based on Dealogic data.
(1) Issuers' nationality and sector are taken to be that of the parent company. Public-sector companies are excluded.

Table a4

Main bookrunners for issues of Eurobonds (1)

(January 1995 - June 2003; millions of euros and percentages)

	Value of issues managed	Number of issues	Market share
Italy			
1 JP Morgan	16,034	51	19
2 Lehman Brothers	15,556	41	18
3 Mediobanca	9,415	36	11
4 Merrill Lynch & Co	6,588	31	8
5 IntesaBci SpA	6,182	45	7
6 Morgan Stanley	5,061	17	6
7 Credit Suisse First Boston	4,816	12	6
8 UniCredito Italiano SpA	4,649	33	5
9 Deutsche Bank	3,319	9	4
10 Citigroup	2,639	8	3
France			
1 BNP Paribas	23,008	90	15
2 Societe Generale	21,008	72	14
3 JP Morgan	11,936	54	8
4 Deutsche Bank	11,817	46	8
5 HSBC	11,019	62	7
6 Morgan Stanley	8,221	61	5
7 Credit Agricole Indosuez	6,847	43	4
8 Citigroup	5,959	31	4
9 Natexis Banques Populaires	5,823	31	4
10 ABN AMRO	5,332	32	3
Germany			
1 Deutsche Bank	40,364	151	18
2 JP Morgan	22,125	57	10
3 Morgan Stanley	18,006	108	8
4 Goldman Sachs & Co	18,003	46	8
5 Citigroup	15,448	47	7
6 Dresdner Kleinwort Wasserstein	14,556	70	6
7 Merrill Lynch & Co	11,433	54	5
8 Credit Suisse First Boston	10,368	47	5
9 BNP Paribas	9,984	33	4
10 Barclays Capital	8,544	32	4

Source: Based on Dealogic data.

(1) In the case of placement syndicates with more than one bank, the value of the issue is divided equally among the participants in the syndicate. Issuers' nationality is taken to be that of the parent company..

Table a5

Gross issues of corporate Eurobonds by sector and nationality of the issuer (1)
(January 1995 - June 2003; percentage distribution by country)

	Italy	France	Germany	United States	Total market
Food products	12.3	4.3	0.7	2.9	3.0
Automobile industry	17.3	17.9	41.1	26.5	24.2
Retailing	1.1	13.8	1.6	3.1	4.0
Construction	2.4	5.6	1.7	0.0	1.1
Electronics/Electrical	0.4	2.3	0.8	1.9	2.0
Oil, coal and gas	0.0	4.3	0.0	3.6	4.1
Energy/Utility	3.0	16.4	13.1	2.0	6.4
Engineering	0.1	3.7	8.1	24.7	15.8
Other industrial products	1.9	5.3	0.1	4.4	5.1
Media	1.8	6.8	1.2	1.3	2.3
Metals and ores	0.7	0.0	0.7	0.0	0.5
Telecommunications	53.2	5.8	23.6	14.3	18.7
Other	5.8	13.8	7.3	15.2	12.8
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Based on Dealogic data.
(1) Issuers' nationality and sector are taken to be those of the parent company. Public-sector companies are excluded.

Table a6

Gross issues of corporate Eurobonds by maturity and nationality of the issuer (1)
(January 1995 - June 2003; percentage distribution by country)

	Italy	France	Germany	United States	Total market
1 year	1.1	2.5	8.2	3.1	3.9
2 years	3.3	11.9	9.5	10.7	10.9
3 years	11.5	10.3	10.0	11.6	11.1
4 years	4.2	5.2	3.6	2.9	3.2
5 years	50.8	25.6	25.4	25.6	27.1
6 years	0.1	7.2	5.0	3.9	4.0
7 years	3.8	18.4	10.3	4.9	7.6
8 years	1.7	1.9	0.7	1.5	1.4
9 years	2.8	0.8	0.0	0.5	0.6
10 years	16.0	10.2	17.3	22.5	19.7
More than 10 years	4.2	6.0	9.8	12.7	10.3
Unknown or perpetual bonds	0.6	0.0	0.2	0.0	0.4
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Based on Dealogic data.
(1) Issuers' nationality and sector are taken to be that of the parent company. Public-sector companies are excluded.

Table a7

Gross issues of corporate Eurobonds by type of coupon and nationality of the issuer (1)

(January 1995 - June 2003; percentage distribution by country)

	Italy	France	Germany	United States	Total market
Fixed rate	57.7	54.8	79.0	82.1	75.1
Variable rate	25.8	20.0	15.0	15.6	17.9
Convertible into shares	16.5	25.2	6.0	2.3	7.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Based on Dealogic data.
(1) Issuers' nationality and sector are taken to be that of the parent company. Public-sector companies are excluded.

Table a8

Cases of default in the period July 1999 - May 2003

	Number of issues	Number of issues	Value of issues (millions of dollars)
1999 (July-December)	60	126	26,352
2000	176	401	50,119
2001	267	688	112,032
2002	192	768	177,486
2003 (January-May)	45	100	18,591

Source: Moody's.

Documents

Bank of Italy Regulation of 27 August 2003 on closed-end investment funds (*)

The regulation of the Bank of Italy of 27 August 2003, [1] issued following Decree No. 47 of 31 January 2003 of the Minister for the Economy and Finance, completes the set of measures implementing the rules on closed-end investment funds enacted by Law 410 of 23 November 2001.

The main new features of the law are:

– specific rules governing real-estate funds that permit the following practices: the subscription of units by means of contributions of assets; investment by the fund in assets sold or contributed directly or indirectly by shareholders of the fund management company or of other companies of the group ("persons with a conflict of interest"); and the taking out of loans up to 60 per cent of the value of real estate and 20 per cent of the value of other assets;

– the possibility for closed-end security and real-estate funds to raise funds by means of more than one issue of units and to redeem units early.

The new rules give managers a broader array of business opportunities and may help increase the competitiveness of the asset management industry, thus fostering its growth.

At the same time, there are also new risks in connection, for instance, with the increased financial leverage made available to real-estate funds or the possibility of transactions involving persons with a conflict of interest. Management companies must identify and deal with these risks appropriately not only by exercising the precautions required by the rules but also by strengthening their organizational structures and corporate governance.

The regulation of 27 August makes changes in the Bank of Italy's rules governing closed-end investment funds in order to adapt them to the new legislative framework. Specifically:

– the new regulation adds to the criteria for the drafting of fund rules contained in the Governor's regulation of 1 July 1998 in order to permit fund rules to include the new operating possibility for real-estate funds. In particular, the rules are now required to specify: whether subscription of fund units by means of contributions of goods is allowed; whether transactions involving persons with a conflict of interest are allowed; and whether the fund intends to make early redemption of units and successive issues thereof. Further, they must indicate the forms in which the company will publish acts of contribution, purchases and sales of goods and the valuation methods and procedures that will be used to determine the value of units in the event of new issues or redemptions;

– it amends Chapter II ("Prohibitions and Prudential Rules for Limiting and Spreading Risk") of the Governor's regulation of 20 September 1999, by revising the criteria for borrowing by real-estate funds and limiting the scope for such funds to invest in companies engaged in construction activity to 10 per cent of their assets;

– it introduces some additions to the Governor's regulation of 24 December 1999 on investment funds' financial reports to provide a fuller description of closed-end funds' business.

(*) Prepared by the Financial Intermediaries Supervision Department. The text of the regulation is available in Italian on the Bank's website www.bancaditalia.it.

[1] Published in *Gazzetta Ufficiale* 209 of 9 September 2003.

Speeches

Guido Carli, Governor of the Bank of Italy

Address by Antonio Fazio, Governor of the Bank of Italy, on the occasion of the Commemoration of Guido Carli on the tenth anniversary of his death

Rome, 23 April 2003

Guido Carli was one of the protagonists of Italian history in the second half of the last century.

His work was always inspired by a comprehensive view of the general interest, by the goal of modernizing Italy's economy, institutions and legal system and by his knowledge of the international framework. In principle, he did not oppose correct forms of public intervention but saw the State as a regulator. He advocated greater competition in the banking system as well as other sectors, but put stability first.

He was a servant of the State, as Governor of the Bank of Italy but also in the many positions he held before and after his Governorship, as an Executive Director of the International Monetary Fund, Head of the European Payments Union, Chairman of Mediocredito Centrale, Minister for Foreign Trade, Chairman of Confindustria, Senator and Minister of the Treasury.

Piero Barucci has given an extensive account of Carli's career and above all of his thinking. I shall recall some aspects of the contribution he made as Governor of the Bank of Italy to the country's economic, political and social development. As Paolo Baffi put it, during the time he held that position "he won the highest regard as he wholeheartedly dedicated his remarkable energies to solving the increasingly grave problems that political and economic developments posed for the monetary authorities." He contributed powerfully to Italy's financial credibility by strengthening "the international community's willingness to support the efforts Italy has made and must continue to make in order to overcome its difficulties".

On another occasion that we are planning, we shall recall Carli's work as an economist in the monetary and financial fields.

Monetary management is a complex art; it demands a good knowledge of economics, experience and the prudent assessment of every decision. Guido Carli possessed this rare combination of gifts. His decision-making ability was extraordinary; he would arrive at a decision after meeting with his collaborators to analyze the causes of the problem and the possible consequences of the alternatives.

The first econometric model of the Italian economy was completed in 1964. It was constructed primarily in response to Carli's calls for data on the performance of the main economic variables and how they related to monetary policy.

He was satisfied with the results and used the model on several occasions to explain the Bank of Italy's policy.

The model is Keynesian in structure. It is updated regularly by the Bank's Economic Research Department and is used to prepare forecasts and to simulate the effects of monetary and fiscal policy measures. The structure has been adjusted to take account of the new institutional order in which policy is implemented by the European System of Central Banks.

Carli took the helm of the Bank of Italy at a difficult time. In 1947 Einaudi and Menichella had tamed the postwar inflation, stabilized the lira and laid the foundations for the "economic miracle". In the 1950s the expansion of the economy and the introduction of more advanced forms of production organization brought considerable gains in productivity in industry and growth in employment.

The growth continued in the 1960s.

In 1959 the lira had won the "currency Oscar". In the early 1960s Carli began to fear that the path of firms' advance was narrowing as a consequence of the expansion of the system of state holdings and the demands for wage increases in excess of the rise in productivity. He called the nationalization of the electricity industry "the first example of the intention of the political class to occupy the economy".

After a long period of cost and price stability, which had brought Italy gains in competitiveness, stimulated growth and spread welfare more widely, new political equilibria fostered a major redistribution of income in favour of payroll employment; there was the risk that profits would come under pressure and investment be reduced.

In the summer of 1963 Carli imposed a credit squeeze in order to limit domestic demand and curb inflation. He did not react to the fierce criticisms of leading political figures; this was his constant policy. Since then the Bank has always responded with the facts and detailed accounts of the reasons for and effects of its actions.

The balance of payments came rapidly back into balance. Carli warned, however, that a restrictive monetary policy was not sufficient, that it was necessary to adapt the structure of supply to the changed composition of demand and achieve gains in competitiveness once more. The discretion attributed to the central bank in its action was based on the assumption that its objective could not be limited to monetary stability; beyond the short term the stability and growth of the economy also had to be ensured.

It was in this period that monetary policy's putative role as stand-in for the other forms of economic policy and its possible economic and institutional effects began to be debated.

In 1969 large increases in prices on international markets led to the adoption of restrictive policies in many countries. In Italy the surge in the budget deficit caused the external accounts to deteriorate. The "hot autumn" of labour conflict caused a fall in industrial production and led to wage rises again outpacing productivity.

In August 1971 the convertibility of the dollar into gold was suspended. The monetary regime created at Bretton Woods was in crisis. In Italy, following the stabilization of 1947, first Menichella and then Carli had ensured an exchange rate of 625 lire against the dollar. Thanks in part to its large balance-of-payments surpluses, Italy had acquired the status of a strong-currency country. Inflation in the 1950s and 1960s was very low by international standards, lower than in Germany.

Carli immediately recognized the importance of the break with the past, giving proof of a lucidity that surprised us youngsters, accustomed to the fixed exchange rate system, and accepted floating rates. I remember the theoretical seminars with the active participation of the members of the Directorate in which Fausto Vicarelli explained the new models for the pursuit of internal and external equilibrium, through public demand and the floating of the exchange rate.

At the end of 1973 the fourfold jump in oil prices intensified the inflationary pressures and threatened the country's financial stability. At the beginning of 1974 inflation exceeded 20 per cent on an annual basis owing to the oil crisis and the enormous balance-of-payments deficit. Carli did not hesitate to impose a tight credit squeeze.

In the absence of an appropriate economic policy strategy, the task of reining in demand fell to the central bank. Recourse was made to supervisory rules and instruments to pursue monetary policy goals.

The dosage of the supply of credit by means of administrative measures, already suggested by Baffi in the second half of 1973 and designed to avoid the rationing of credit to small and medium-sized enterprises, was applied to all bank lending.

Stabilization was achieved in the context of an agreement with the International Monetary Fund concluded on conditions that were the result of extremely tough negotiations. In a letter of intent Italy undertook to meet an intermediate objective defined in terms of total domestic credit. The conditions laid down by the International Monetary Fund, revised in the light of estimates obtained with the econometric model, brought down the government of the day and were only accepted by a new one that was politically committed to the credit restrictions imposed by the Bank of Italy.

The intervention had the desired effect of curbing demand; the deterioration in the balance of payments and the depreciation of the lira were halted. The inflation rate was halved, from more than 20 per cent on an annual basis to around 10 per cent. The stringency of the 1974 credit tightening was second only to that of the squeeze imposed in 1947; the economy and the financial system had risked a crisis that I have no hesitation in defining as potentially disastrous.

During the annual meeting of the International Monetary Fund in October 1974 Carli put forward a proposal for recycling the petrodollars that exceeded the development needs of the Arab OPEC countries – “a sort of Marshall plan on a world scale”, as he called it. In this and other proposals concerning international relations it is possible to discern an “ante litteram” vision of the phenomena present in financial globalization.

Faced with the crisis described above, he had deemed that a refusal to finance the State would have been a “seditious act”, even though such funding might distort the market and prolong inflation. This decision should not be interpreted as acquiescence in inflationary policies but as the thinking of a conscientious public servant who, holding one of the key positions in the institutional order, recognized the ultimate authority of Parliament’s sovereign will.

There was concern for a political and institutional setting that lacked stability. Partly owing to those reflections and in a different institutional context, we now have precise statutory rules deriving from the Constitution and Community law.

That it was not a question of surrender can be seen from Guido Carli’s influence, strengthened by the international acclaim he enjoyed, on the action of the Government, which, engrossed by the difficulties on the political and labour relations fronts, sometimes risked losing sight of the objective of monetary stability.

In 1975 Carli was succeeded by Paolo Baffi at the start of what Baffi was later to call “five years under fire”. The economy deteriorated against a background of social and political strains marked by the outbreak of terrorist violence.

The Bank that Carli left had increased its authority in the country and abroad. It had coped skillfully with serious crises that were overcome through the use of monetary policy. In a delicate period of transition in political and institutional relations, it had consolidated its independence and built up the range of instruments at its disposal; it had constantly drawn attention to the ills of the real economy and the public finances.

The vision that guided Carli was liberal, not laissez-faire, and attentive to solidarity and social cohesion, without this being confused with visions that justified waste or parasitism. At times he was pessimistic, as when the electricity industry was nationalized. He never failed, however, to serve the State loyally, as when he committed the Bank and its branches to a demanding analysis of the issues related to the planning process which the Government of the day intended to introduce and which contrasted sharply with his own ideas.

Carli had entered the Bank as Director General at just 45, and immediately felt himself part of the institution.

In accordance with his view of the Bank of Italy as an economic authority, embodied in Italy's de facto constitution, Carli strengthened banking supervision, started a process designed to make the regulation of the monetary base less dependent on the Treasury's financing needs, and tenaciously and sagaciously fostered economic and institutional research.

The times were changing. It was necessary to create, under the existing laws, a new framework for the powers and functioning of the supervisory authority, to clarify its aims and to define its relations with both the ordinary and the administrative judicial authorities.

A substantial increase in the number of inspectors was gradually implemented, starting from 60 in 1968. Today, there are 160 working out of the Head Office and the same number again working out of branches. Drawing also on experience in other countries, the methods and instruments for carrying out inspections were revised, binding rules concerning the transparency and disclosure of banks' annual accounts were laid down, including the requirement to disclose hidden reserves, a farsighted choice that also contributed to banks not being involved in the numerous episodes of corruption that came to light in the 1990s.

Decades later, banking supervision has taken on far greater importance than in Carli's times. But the seed sown then has borne abundant fruit. For Carli, intellectual consistency and rigour, together with a clear recognition of the aims, were the prerequisites for earning merit. They are principles which are not undermined by the sporadic virulence of vested interests seeking to appear as the general interest.

The Bank of Italy owes its transformation into a modern central bank to Guido Carli.

Donato Menichella believed in "fuge rumores"; he was diffident of any relationship with the press and claimed with dry humour that there was no basis for such relations since one could not recount the truth yet had the moral duty not to tell lies.

However, as Baffi had occasion to remark, "the actions of central banks have left the realm of silence, perhaps never to return; if in the past silence was seen as a guarantee of independence, today independence is achieved by giving explicit account of one's action in ways and at times that do not prejudice its effectiveness".

The innovations in monetary policy, the enhancement of banking supervision and research were also possible because Carli, at the very beginning of his Governorship, launched a major drive to renew and strengthen the Bank's staff and internal organization. Special attention was paid to personnel management, to allow the Bank to attract the best of the new generations and carefully instruct them in its working practices.

He gave greater responsibility to younger members of the staff and involved them directly in the decision-making process.

The Central Credit Register was created in 1962 and the School of Automation for Bank Executives was set up in Perugia in 1968. The Interbank Convention on Automation was established, the department responsible for foreign relations was completely reorganized, forms of "participation" were introduced into relations with the trade unions. Lastly, Via Nazionale-Via Tuscolana was chosen as the axis of expansion of the Bank's main premises.

Carli was a precursor of the direction in which the role of central banks would evolve, especially in Europe. As Treasury Minister of the Government headed by Giulio Andreotti, he signed the Maastricht Treaty.

But these values, today reinforced in the European context, had already become, thanks in significant measure to Guido Carli, a central element in our laws and in the Bank's institutional and organizational tradition.

In 1976 Carli succeeded Giovanni Agnelli as Chairman of Confindustria; in taking on this task, he gave further proof that he was a "practical intellectual". Following his election to the Senate, in 1989 he was appointed Minister of the Treasury. In this new role he explicitly adopted the policy of turning the proposals of the Bank of Italy into Treasury decisions. He completed, in formal terms, the project to make the Bank entirely independent by promoting the law that transferred the power to fix the official discount rate to the Governor.

Italy has made important progress since the years of Carli's Governorship.

The terms of the relationship between banks and firms are no longer the same as those of Carli's proposal to transform bank loans into equity holdings. In several periods after that proposal major restructurings took place in industry and more recently, since the mid-1990s, the banking system has been restored to a sound footing and consolidated.

The question of structural reforms, which can no longer be put off, can also be seen as a development of the analyses and lucid diagnosis of the fragility and limits of the Italian economy that Carli put forward in the 1970s. Innovation, competitiveness, productivity and the role of our productive system in the world economy are issues repeatedly addressed in all the Bank's Annual Reports.

Today it is essential to revive the growth of the economy: strategies and policies in this age of globalization are more complex than they used to be. Carli's writings and work can still help us.

There are moments when we miss Carli, his thinking, his ability to devise projects at a time when we are faced with the need to re-establish equilibria, behaviour and rules among states, so as to foster distension and peaceful cohabitation at the international level. A time when Europe should play a very different role.

We are grateful to Guido Carli for what he did, for what he left us. We are proud of the work he did, of the contribution he made to the international community and to Italy.

Fact-finding preliminary to the examination of the budget documents for the period 2004-06

Statement by Antonio Fazio, Governor of the Bank of Italy, to the Joint Session of the Fifth Committees of the Italian Senate and Chamber of Deputies

Rome, 10 October 2003

1. The international setting and the Italian economy

1.a *The international economy*

The world economy appears to have shaken off the stagnation that lasted from the autumn of 2002 until this spring. With the end of the conflict in Iraq signs of improvement gradually emerged, first in the financial indicators and then in the real economy. Expectations are for a pick-up in economic activity in the rest of the year, albeit of differing strength in different parts of the world.

In the United States, the slow growth of the fourth quarter of 2002 and the first quarter of this year has given way to faster expansion, with GDP rising at a 3.3 per cent annual pace in the second quarter. Contributory factors included the exceptionally large increase in military spending, an acceleration in household consumption and a recovery in productive investment. Economic activity strengthened further in the third quarter to grow at an annual rate of about 5 per cent. In September the contraction in employment came to a halt.

The International Monetary Fund's latest forecast is for US growth of 2.6 per cent this year, rising to 3.9 per cent in 2004. The acceleration is the result of the persistence of highly expansionary monetary conditions and the unfolding effects of the budget measures passed last May. Maintaining the rapid pace of US growth requires that the state of the labour market continue to improve. Causes of concern include the steady deterioration of the current account of the balance of payments, which is significantly affecting the exchange rate of the dollar, and the public finances. The latest estimates of the Congressional Budget Office indicate a widening of the overall federal government deficit from 1.5 per cent of GDP in the 2002 fiscal year to 3.7 per cent in 2003 and 4.3 per cent in 2004.

In Japan GDP grew faster than had been expected in the first half of 2003, fueled by a strong expansion of exports to other Asian countries and by accelerating investment. The IMF forecasts output growth of 2 per cent this year, and growth should continue next year as well.

The Chinese economy grew by around 8 per cent in the first half compared with the first half of 2002. In Latin America economic activity is strengthening; in a number of countries, most notably Brazil, financial conditions and the climate of confidence have laid the basis for an upturn in production.

1.b *The euro area and Italy*

The cyclical weakness that has affected the main euro-area economies for about a year now became more pronounced in the first half of 2003. In France GDP declined in the second quarter at an annual rate of 1.3 per cent, following growth of 0.3 per cent in the first quarter. In Germany economic activity contracted by 0.6 per cent on an annual basis in the first half. Following the temporary upswing of the second half of 2002, Italy returned to stagnation in the first six months of this year.

Italian economic performance was affected by the decline in exports, which fell by nearly 12 per cent on an annual basis in the first half. The export contraction was sharper than in Germany and France (2.7 and 5.5 per cent respectively). World trade is estimated to have expanded by about 1 percentage point.

The loss of world market shares was considerably more severe for Italy than for the rest of the euro area. There was a partial export recovery in the summer months. For the first three quarters as a whole, the downward trend in market shares that began in the mid-nineties continued. Italian exports have suffered a substantial loss in price competitiveness over the past two years, owing partly to the appreciation of the euro. The country continues to specialize in products that are heavily exposed to competition from the emerging economies.

Between the fourth quarter of 2000 and the fourth quarter of 2002, Italy's export competitiveness deteriorated by 7.5 per cent, compared with 5.5 per cent for Germany and 3.7 per cent for France. It declined by another 4 per cent in the first half of 2003.

In the first half of this year Italian domestic demand was sustained mainly by a build-up in stocks, which fueled annualized GDP growth of nearly 2.5 per cent.

Reflecting the modest rise in purchasing power, the growth in households' expenditure slowed to 1.8 per cent from 2.5 per cent in the second half of 2002.

Capital formation diminished at an annual rate of 7.7 per cent.

According to the official indices produced by Istat, the harmonized twelve-month rate of consumer price inflation in Italy dipped to 2.7 per cent in August but then rose to 2.9 per cent in September. The rate for the euro area as a whole has been around 2 per cent since the spring. Service prices are marked by greater stickiness in Italy, which has not yet seen the gradual deceleration in this sector that the other major economies experienced following the temporary rise originating with the changeover to the euro.

According to the Italian national accounts, the number of persons employed increased by 0.9 per cent in the first half and employment was 1.3 per cent higher than in the first half of 2002. The labour force survey conducted in July, however, showed a halt to the growth, with employment remaining at its April level. After a protracted reduction the unemployment rate stabilized at 8.7 per cent; in August it was 9.4 per cent in Germany and France and 11.4 per cent in Spain.

Signs of a cyclical upturn emerged during the summer, despite the persistence of widespread uncertainty over the timing and strength of recovery. On average the climate of confidence in Italian industry has improved in the last two months. However, the index of confidence for households remains low. The September survey indicates a slight improvement, confirmed by the rebound in new car registrations.

Industrial production is expected to expand by about half a percentage point on average in the third quarter, ending the downward trend that set in towards the end of 2002.

The hypothesis of a modest increase of around 0.2 per cent in Italian GDP in the third quarter is reasonable. In the absence of a significant improvement in the last quarter, economic growth for the year as a whole will come to less than half a percentage point.

The achievement of year-on-year growth of 1.9 per cent in 2004 would require a growth rate of more than 3.0 per cent during the year.

2. The public finances in 2003

The Economic and Financial Planning Document of July 2002 indicated a net borrowing target of 0.8 per cent of GDP for 2003. The target for the primary surplus was set at 5.1 per cent of GDP. Economic growth was forecast at 2.9 per cent.

In September 2002 the Planning Document Update raised the target for net borrowing to 1.5 per cent of GDP in view of the deterioration in the fiscal balances and the downward revision of forecast growth to 2.3 per cent. The planned primary surplus ratio was lowered to 4.5 per cent. The aim was to reduce the debt ratio by 4.4 percentage points.

To achieve the objectives a budgetary correction on the order of 1 per cent of GDP was approved. The correction consisted largely of temporary measures.

In April 2003 the Quarterly Report on the Borrowing Requirement and the Update of the Forecasting and Planning Report for 2003 cut forecast growth to 1.1 per cent. The estimate for net borrowing was now put at 2.3 per cent of GDP, the same as the outturn for 2002. Both the state sector and the public sector borrowing requirements were expected to increase substantially with respect to 2002, the former from 2.1 to 3.2 per cent of GDP and the latter from 3.2 to 3.6 per cent.

The Economic and Financial Planning Document for 2004-2007 published in July basically confirmed the estimates regarding the public finances. By contrast, the forecast for GDP growth in 2003 was lowered to 0.8 per cent.

The Planning Document Update and the Forecasting and Planning Report of September further reduced the estimate of GDP growth to 0.5 per cent and revised general government net borrowing and the state sector borrowing requirement upwards again, estimating them at 2.5 and 3.5 per cent of GDP respectively. The general government primary surplus is now expected to fall to 2.8 per cent of GDP this year and the debt ratio to decrease by 0.7 percentage points, from 106.7 to 106 per cent.

The present estimate for net borrowing is one percentage point higher than the objective set in the autumn of 2002. The primary surplus is 1.7 points lower; the decrease is partly a consequence of the reduction in expected growth for the current year.

Primary current expenditure is expected to increase by 4.4 per cent, compared with the forecast of 2.9 per cent a year ago; as a ratio to GDP it is expected to rise to 38.5 per cent, 0.3 percentage points higher than in 2002.

Revenue from the tax regularization schemes has been appreciably higher than the initial estimates. The budget revision bill puts the revenue for this year at almost €13 billion; in addition there will be the receipts of the instalment to be paid in 2004, which will be accounted for in 2003 for the purposes of net borrowing. According to the Government's estimates, the ratio of receipts of taxes and social contributions to GDP will increase by 0.6 percentage points; excluding the regularization schemes, it would decrease by about half a point.

The increase in revenue from the tax regularization schemes is partly offset by the postponement to 2004 of the planned securitizations of real-estate.

The impact of the measures with temporary effects, such as regularizations and real-estate sales, amounts to around 1.5 per cent of GDP, similar to the figure of 2002 and about three times that of 2001. These estimates do not consider the temporary expense arising from investment incentives, which is difficult to assess.

Taking account of the adverse effects of the economic cycle on the budget balance and the positive effects of temporary measures, the structural primary surplus can be estimated at just under 2 per cent of GDP.

The general government net borrowing requirement amounted to around €32 billion in the first eight months of 2003, €2 billion less than in the corresponding period of 2002.

The state sector borrowing requirement, net of settlements of past debts and privatization receipts, totaled €44 billion in the first nine months of the year, €3 billion more than in the same period of 2002.

The gap between the borrowing requirement and net borrowing has begun to grow again.

The reduction indicated in the debt ratio implies substantial additional measures.

3. The public finance objectives for 2004

In July the Economic and Financial Planning Document set a net borrowing objective for 2004 of 1.8 per cent of GDP. The projected deficit on a current legislation basis was 3.1 per cent. Economic growth was forecast at 2 per cent.

To achieve the objectives, the Planning Document provided for a budget adjustment of around €16 billion, or 1.2 per cent of GDP; €5.5 billion was to come from structural measures.

The Planning Document Update and the Forecasting and Planning Report for 2004 has raised the objective for net borrowing to 2.2 per cent of GDP. The forecast for interest payments has been increased to 5.1 per cent of GDP, the expected primary surplus reduced to 2.9 per cent. By contrast, the forecasts for GDP growth and net borrowing on a current programmes basis are basically unchanged.

With the revision to 2.2 per cent of the objective for net borrowing, the size of the budget correction has been reduced to €11 billion; the €16 billion of deficit-reduction measures envisaged in the Planning Document in July are now accompanied by €5 billion of measures to support growth.

The forecasts include expenditure savings of between €2 billion and €3 billion as a consequence of the removal of the National Road Agency (Anas) from general government.

The planned state sector borrowing requirement is equal to 3.7 per cent of GDP, compared with 3.4 per cent in the July Planning Document. The gap with respect to net borrowing is wider. The debt ratio is to fall by one percentage point.

The revenue ratio is expected to fall by around one percentage point, mainly as a consequence of the disappearance of the extraordinary revenue from the 2003 regularization schemes. The primary current expenditure ratio is to decrease by two tenths of a point. The expected fall in capital expenditure from 4.2 to 3.5 per cent of GDP reflects the sales of real-estate planned for 2004 and the above-mentioned removal of Anas from the general government accounts.

4. The budget for 2004

The budget is defined by the Finance Bill and by Decree Law 269/2003; it provides for a correction to net borrowing of €11 billion, or 0.8 per cent of GDP.

The measures to reduce the deficit amount to €16 billion, of which €14.3 billion from increases in revenue and €1.7 billion from decreases in expenditure.

Measures totaling around €5 billion are envisaged to support the economy, of which €2.8 billion in the form of increased outlays and €2.2 billion of reductions in revenue.

The one-off component of the package, mainly on the revenue side, amounts to around €10 billion, or less than in 2003.

4.a *Revenue*

The increases in revenue, amounting to €14.3 billion, are nearly all of a temporary nature; the expected receipts from the measure regarding social security contributions of persons working under coordinated and continuous collaboration contracts and from the revision of the taxation of video games and betting are exceptions.

Regularization schemes are expected to bring in €7.6 billion. In particular, the plans are for a condonation of building offences, an ex-ante agreement with firms regarding income tax liabilities for 2003 and 2004, and the postponement to 2004 of the reopening of the regularization schemes introduced with the Finance Law for 2003.

In addition, there are plans for sales of real estate, to be carried out partly through securitizations, yielding €5 billion.

The €2.2 billion reduction in revenue is temporary. Almost half of the decrease does not correspond to actual relief but is due to the payment of some excise duties on mineral oils having been brought forward to 2003. The other measures consist mainly of extensions of reliefs regarding indirect taxes.

The tax incentives for businesses include a one-year exclusion of a part of firms' research and development costs from taxable income and a two-year reduction to 20 per cent of the corporate income tax rate for companies that become listed on a regulated market in the European Union in 2004. These measures will not have a significant impact on revenue next year.

In 2004 firms will also be affected by the entry into force of the provisions regarding the new corporate income tax, which are not part of the budget. A reduction of the tax rate to 33 per cent is among the proposed provisions.

The net increase in revenue amounts to €12.1 billion.

4.b *Expenditure*

The planned expenditure reduction measures, amounting to €1.7 billion, mainly concern public employment and the transformation of the Cassa Depositi e Prestiti and SACE into companies limited by shares. For a part of its activities the Cassa would be acting as a credit institution and as such would be subject to all the provisions of the Consolidated Law on Banking. Simply changing the legal form of the Cassa has no implications for the net public debt; the impact on the gross public debt will depend on how the Cassa's assets and liabilities are reallocated and on its financial transactions with the State.

The removal of the Cassa Depositi e Prestiti and SACE from general government is expected to reduce expenditure by €0.9 billion. The freeze on hirings and the restrictions on the use of fixed-term employees are expected to save €0.5 billion. Other minor measures are seen as curbing current expenditure by around €0.3 billion.

The increase in expenditure of €2.8 billion is mainly attributable to public employment, workfare programmes for the unemployed and support for road hauliers.

The increase in expenditure on public employment amounts to €1.1 billion. It includes allocations to cover the renewal of labour contracts and additional health sector staff costs for the two years 2002-03. The spending on workfare programmes in schools is estimated to be €0.4 billion, while that arising from the extension of the support for road hauliers is estimated to be €0.3 billion. International missions and allowances for second and subsequent children are expected to cost an additional €0.3 billion. Other minor measures are expected to increase current expenditure by €0.5 billion and capital expenditure by €0.2 billion.

On a net basis the budget will increase expenditure by €1.1 billion.

5. Evaluation of the budget

The scenario for 2004 set out in the Economic and Financial Planning Document published in July contained some elements that were at risk. The Planning Document Update published at the end of September left the baseline budget estimate of net borrowing unchanged despite new information, such as the inclusion in the accounts for 2003 of instalments of tax regularization schemes payable in 2004 and the upward revision of the estimate of interest payments.

The budget seeks to reconcile curbing the deficit in 2004 with strengthening the policies designed to stimulate public and private investment and support household demand.

The planning framework indicates virtually no change in relation to GDP in general government capital expenditure (excluding sales of real estate and the effects of the transformation of the National Road Agency (Anas) into a company limited by shares). By involving the private sector, the activity of Infrastrutture S.p.A. is intended to permit the implementation of the Government's extensive and multifaceted programme of public works.

The boost for private investment is entrusted to new incentives aimed at fostering expenditure on research and development. The results obtained with the investment incentives introduced in the last few years indicate that they are effective when the economy is expanding; they cannot permanently replace the stimulus to invest deriving from a favourable economic environment; they may influence the timing of projects. As regards research and development, a lasting increase in Italian firms' ability to innovate requires a consistent plan to be drawn up for the modernization of the productive system.

The support for household spending mainly concerns the tax incentives for the renovation of buildings and the allowances for children after the first. It should be noted that the former are extensions of measures introduced in earlier years and which have brought a significant increase in economic activity. The latter's effectiveness would be increased by a comprehensive revision of the whole system of social benefits and services for households.

The measures to curb the deficit are mostly on the revenue side. The net effect of those on the expenditure is to increase the deficit. As in previous years, the bulk of the increase in revenue derives from one-off measures.

The use of temporary measures makes it possible to reduce the repercussions on economic agents' spending decisions in an unfavourable phase of the cycle. However, the bunching of large payments may nonetheless cause households and firms to be subject to liquidity constraints.

Some measures may lead to higher expenditure of revenue losses in future years. The repeated recourse to regularization schemes gives rise to uncertainty regarding the cogency of the law; there may be problems in their application.

The deferred fulfilment of economic agents' expectations of measures to bring about a structural adjustment of the public finances may have adverse effects on investment and the outlook for growth.

It is necessary to adopt measures to curb primary current expenditure and create the conditions for a lasting return of Italy's public finances to a position close to balance.

The period of rapidly falling interest payments in relation to GDP is drawing to an end. Primary current expenditure is still a slightly higher percentage of GDP than in the second half of the 1990s; only determined action to limit its growth can make room for a gradual reduction in the tax burden. Excluding the revenue generated by regularization schemes, the ratio of taxes and social security contributions to GDP should be slightly lower in 2004 than this year.

6. Medium-term prospects. Conclusions

In its planning documents the Government sets out an economic policy designed to sustain growth and employment and gradually reduce the deficit.

In a context of cyclical weakness of the economy, the postponement in recent years of measures to restore a balanced budget has put a brake on the decline in the ratio of debt to GDP.

Last July's Economic and Financial Planning Document predicted that budget balance would be achieved in 2007, a year later than indicated in the *Stability Programme* of November 2002. Despite the higher level of net borrowing projected for 2003 and 2004, the Planning Document Update of last September basically confirms the objective to be achieved in 2007 and envisages more ambitious corrective measures in the three years 2005 to 2007.

A balanced budget will rapidly bring down the debt ratio.

Since the baseline projection has been determined on a current legislation basis, which does not take account of the cost of labour contract renewals and new investment projects, the corrective measures will need to be larger than just the difference between that projection and the planning forecast.

The primary surplus has fallen continuously in recent years, decreasing by almost half in relation to GDP, from 6.7 per cent in 1997 to 3.4 per cent in 2002. Current estimates set it even lower in 2003, at 2.8 per cent of GDP, with little change in the following year. In line with the commitments entered into at the start of the monetary union, this balance is expected to rise above 5 per cent of GDP in 2007 as a consequence of the more rigorous measures scheduled for 2005-2007.

On the assumption that no new one-off measures are introduced and that capital expenditure and revenue remain unchanged in relation to GDP, achieving balance in 2007 would require, bearing in mind the forecasts for interest payments, the growth of primary current spending to be curbed sufficiently to bring down its ratio to GDP by almost 3.5 percentage points. A larger adjustment would leave room to continue the policy of reducing the tax burden and to step up general government investment.

Looking ahead, the consolidation of the public finances remains a fundamental prerequisite for creating an economic climate conducive to investment and growth.

The credibility of a strategy to restore balanced public finances on a permanent basis depends on identifying clear lines for the reform of the main expenditure items.

An analytical breakdown of general government revenue and expenditure will make it easier to develop programmes and evaluate the effects of measures. A substantial contribution to achieving this will come from Parliament's work on the reform of the national accounts.

Stronger efforts are needed to raise the productivity of public services. The absence of legislation spelling out the financial relationships between the different levels of government weakens the incentives to make efficient use of resources. Institutional reforms must address the reorganization of the machinery of government to better satisfy the needs of the citizenry.

We must continue to raise the level of public investment in infrastructure, develop strategies to support research and innovation, reverse the tendency to lose competitiveness and make good the delay in the production of high-technology goods.

The ability to convince economic agents that there is a will and a way to adjust the public finances and reduce the tax burden will generate consensus for the necessary reforms and an economic policy aimed at achieving growth and higher employment.

Annex

The need to reform the pension system

On the matter of pensions, which are the subject of an amendment to the enabling bill, no decision has yet been reached about the technical link in Parliament with the provisions to be adopted in the budget session.

The need for a reform of the pension system to complete the changes introduced in the 1990s is the consequence of the continuous and pronounced ageing of the population.

The average effective retirement age is usually around 60 today. Life expectancy at that age, which was 17 years for men and 19 for women in 1960, has now reached 20 and 25 years respectively; it is destined to rise further, to 24 and 29 years in 2030. This improvement, combined with the drop in the birth rate and consequent fall in the number of working-age citizens, is inexorably increasing the ratio of old people to the active population. The dependency ratio, which was 14 per cent in 1960, rose to 27 per cent in 2000 and will reach around 46 per cent in 2030.

In 2000 the main pension schemes paid out 88 pensions for every 100 people employed. Despite the recent reforms, the State Accounting Office estimates that the number of pensions per 100 workers will be 94 in 2020 and 110 in 2030.

In this situation, the only way to guarantee workers the same replacement ratio, that is the ratio of pension to income, is a gradual but timely increase in the retirement age. In this way it will be possible to contain expenditure while maintaining the standard of living of older citizens.

Demographic trends and the evolution of the structure of the family put pressure on expenditure in other sectors as well, including health care and long-term assistance. It may even become necessary to increase other social benefits, such as those for unemployment and allowances for the indigent.

A systematic and global review of the legislation will reduce citizens' uncertainty. It will then be possible to safeguard one of the most important social advances of the twentieth century, for the benefit of future generations as well.

The legislative changes in the field of social security, which it will be possible to analyze in depth as soon as their progress through Parliament begins and their contents are established, can mark a step in the right direction for the reform of the pension system.

Table 1

Unconsolidated central government borrowing requirement
(millions of euros)

	Year			First 8 months		
	2000	2001	2002	2001	2002	2003 (2)
Net borrowing requirement (net of debt settlements and privatization receipts) (1)	**29,766**	**34,814**	**27,418**	**20,729**	**32,688**	**32,597**
Debt settlements	4,601	10,291	5,929	6,661	1,832	4,883
- *in securities*	*2,665*	*563*	*1*	*357*	*1*	*573*
- *in cash*	*1,937*	*9,728*	*5,928*	*6,304*	*1,831*	*4,310*
Privatization receipts (3)	-15,450	-4,329	-2,031	-4,321	-178	-1
Total borrowing requirement (1)	**18,917**	**40,775**	**31,317**	**23,069**	**34,343**	**37,479**
FINANCING						
Medium and long-term securities	18,691	12,049	21,468	15,451	30,623	19,461
Treasury bills	-17,550	11,717	-70	18,986	16,826	22,855
Treasury current accounts with BI	9,708	-2,119	212	-19,621	-16,348	-19,259
Other Bank of Italy net financing	-1,515	-1,930	2,045	125	2,051	105
Post Office funds	4,660	10,919	7,287	4,659	3,226	4,717
Bank lending (4)	-6,434	-2,375	-1,819	-3,323	-3,788	-1,919
Other domestic financing	1,308	4,761	-480	-390	-373	1,759
Foreign loans (5)	10,050	7,751	2,671	7,181	2,126	9,760
Memorandum item:						
Net borrowing requirement of the state sector (1)	27,386	33,547	26,040	20,898	33,808	33,400

(1) A plus sign indicates a deficit, a minus sign a surplus. – (2) Provisional data. – (3) Includes the part of the proceeds of the sale of UMTS licences received in 2000 and used to reduce the public debt (10,709 million euros). The remaining part (1,190 million euros) was recorded under revenue. – (4) Includes redemptions of loans granted to local authorities. – (5) Includes commercial paper.

Table 2

General government borrowing requirement

(millions of euros)

	Year			First 8 months		
	2000	2001	2002	2001	2002	2003 (2)
Net borrowing requirement (net of debt settlements and privatization receipts) (1)	**35,959**	**37,314**	**33,442**	**19,603**	**34,090**	**31,964**
Debt settlements	4,601	10,291	5,929	6,661	1,832	4,883
- in securities	*2,665*	*563*	*1*	*357*	*1*	*573*
- in cash	*1,937*	*9,728*	*5,928*	*6,304*	*1,831*	*4,310*
Privatization receipts (3)	-15,450	-4,329	-2,031	-4,321	-178	-1
Total borrowing requirement (1)	**25,110**	**43,275**	**37,341**	**21,942**	**35,744**	**36,846**
FINANCING						
Medium and long-term securities	18,873	13,592	22,114	15,943	30,332	18,700
Treasury bills	-17,466	11,293	274	18,930	17,023	22,865
Treasury current accounts with BI	9,708	-2,119	212	-19,621	-16,348	-19,259
Other Bank of Italy net financing	-1,515	-1,930	2,045	125	2,051	105
Post Office funds	4,660	10,919	7,287	4,659	3,226	4,717
Bank lending (4)	-2,799	-2,442	-1,806	-5,604	-3,780	-2,740
Other domestic financing	1,308	4,761	-480	-390	-373	1,759
Foreign loans (5)	12,342	9,199	7,692	7,901	3,614	10,700

(1) A plus sign indicates a deficit, a minus sign a surplus. – (2) Provisional data. – (3) Includes the part of the proceeds of the sale of UMTS licences received in 2000 and used to reduce the public debt (10,709 million euros). The remaining part (1,190 million euros) was recorded under revenue. – (4) Includes redemptions of loans granted to local authorities. – (5) Includes commercial paper.

Table 3

Estimated effects of the budget on the general government consolidated accounts (1)
(millions of euros)

REVENUE	
Increase in revenue	**14,310**
Sales of real estate (2)	5,000
Ex-ante tax agreement (2)	3,580
Regularization of building offences (2)	3,090
Indemnity for prior occupation of state property (2)	460
Video games and betting (2)	670
Social security contributions (2)	630
Deferred reopening of tax regularization schemes (2) (3)	500
Other (2)	380
Decrease in revenue	**-2,180**
Effect of the early payment of excise duties in 2003 (2)	-980
Extension of agricultural tax reliefs (4)	-750
Extension of partial VAT deductibility for company cars (4)	-160
Extension to 2004 of excise duty reliefs (2)	-140
Other (2) (4)	-150
NET CHANGE IN REVENUE	**12,130**
EXPENDITURE	
Reduction in expenditure	**-1,680**
Transformation of Cassa Depositi e Prestiti and SACE (2)	-890
Public employment (4)	-500
Social security (2)	-100
Other current expenditure (2) (4)	-190
Increase in expenditure	**2,770**
Public employment (4)	1,120
Extension of workfare programmes in schools (4)	350
Extension to 2003 of support for road hauliers (2)	320
International peace missions (4)	200
Allowance for second and subsequent children and social policies (2)	130
Other current expenditure (2) (4)	500
Investment (4)	150
NET CHANGE IN EXPENDITURE	**1,090**
TOTAL REDUCTION IN PRIMARY NET BORROWING	**11,040**

(1) Based on official estimates. – (2) Measures included in Decree Law 269/2003. – (3) The amount shown is that indicated in the technical report accompanying the decree law for payments in 2004. The report expects another 370 million euros to be paid in 2005. – (4) Measures contained in the Finance Bill.

Table 4

Budget forecasts in the economic and financial planning documents for 2003-06 and 2004-07 and the September 2003 planning document update (1)

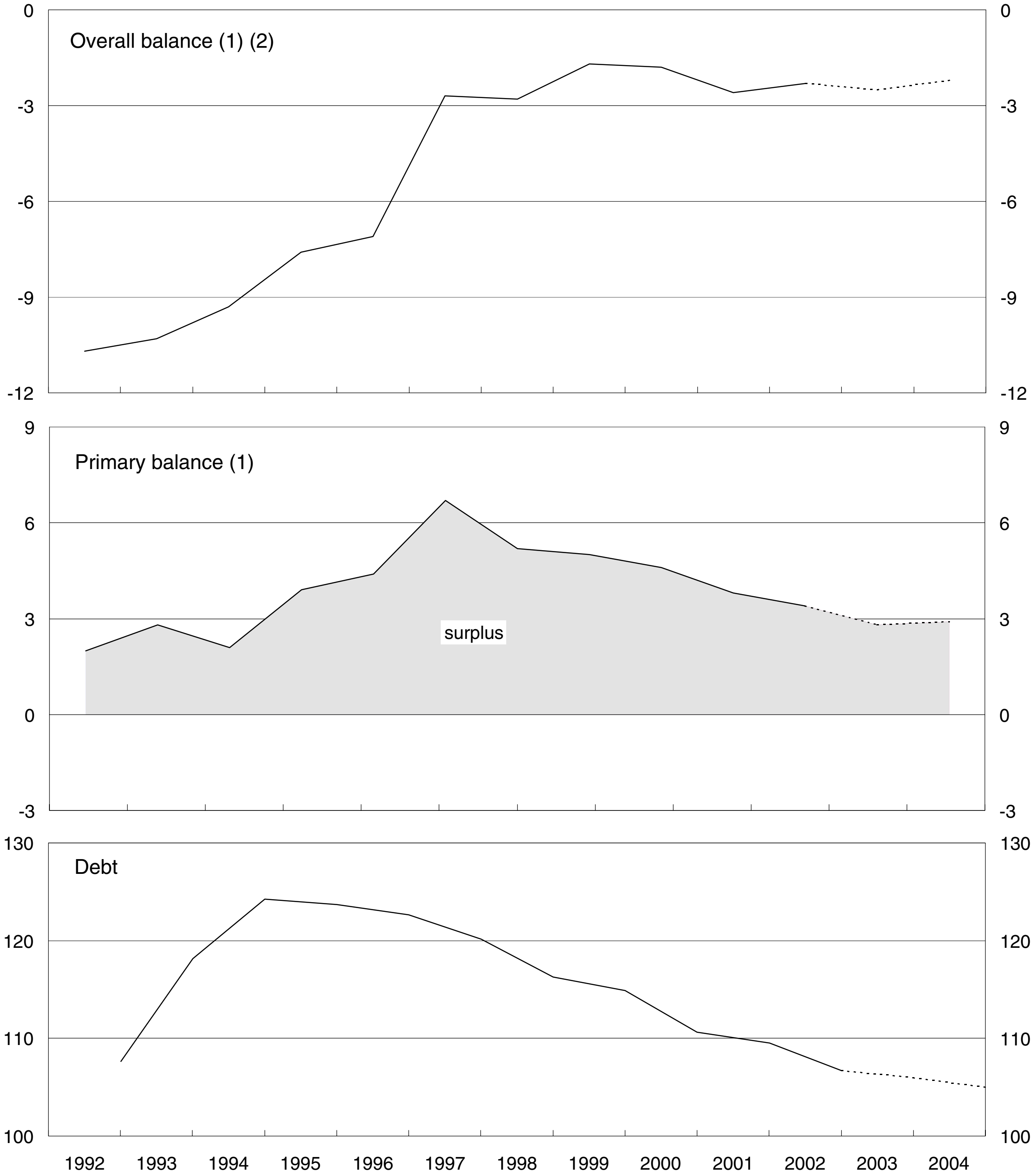
(as a percentage of GDP)

	2002	2003			2004			2005			2006			2007	
	Outturn	EFPD 2003-06	EFPD 2004-07		EFPD 2003-06	EFPD 2004-07		EFPD 2003-06	EFPD 2004-07		EFPD 2003-06	EFPD 2004-07		EFPD 2004-07	
			July	Sept. (2)		July	Sept. (2)		July	Sept. (2)		July	Sept. (2)	July	Sept. (2)
Net borrowing	2.3	0.8	2.3	2.5	0.3	1.8	2.2	-0.1	1.2	1.5	-0.2	0.5	0.7	-0.1	0.0
of which: current	*-0.7*	*-2.2*	*na*	*0.1*	*-2.7*	*na*	*-0.5*	*-2.7*	*na*	*na*	*-3.1*	*na*	*na*	*na*	*na*
capital	*3.0*	*3.0*	*na*	*2.4*	*3.0*	*na*	*2.8*	*2.6*	*na*	*na*	*2.9*	*na*	*na*	*na*	*na*
Primary surplus	3.4	5.1	3.0	2.8	5.5	3.1	2.9	5.8	3.8	3.5	5.7	4.6	4.4	5.2	5.1
Total revenue	44.9	na	na	45.6	na	na	44.7	na	na	na	na	na	na	na	na
of which: taxes and social security contributions .	*41.6*	*41.9*	*na*	*42.2*	*41.4*	*na*	*41.1*	*40.4*	*na*	*na*	*39.8*	*na*	*na*	*na*	*na*
Primary expenditure	41.6	na	na	42.8	na	na	41.8	na	na	na	na	na	na	na	na
of which: current	*38.2*	*na*	*na*	*38.5*	*na*	*na*	*38.3*	*na*	*na*	*na*	*na*	*na*	*na*	*na*	*na*
capital	*3.4*	*na*	*na*	*4.2*	*na*	*na*	*3.5*	*na*	*na*	*na*	*na*	*na*	*na*	*na*	*na*
Interest payments	5.7	5.9	5.3	5.3	5.8	4.9	5.1	5.7	5.0	5.0	5.5	5.0	5.1	5.1	5.1
Debt	106.7	104.5	105.6	106.0	99.8	104.2	105.0	97.1	101.7	103.0	94.4	99.4	100.9	97.1	98.6

(1) Rounding may cause discrepancies in totals. – (2) Update of the Economic and Forecasting Planning Document for 2004-07, presented by the Prime Minister for the Economy and Finance on 30 September 2003, and, for the item taxes and social security contributions, the Forecasting and Planning Report for 2004, presented by the Minister for the Economy and Finance on 29 September 2003.

Figure 1

General government overall balance, primary balance and debt
(as a percentage of GDP)

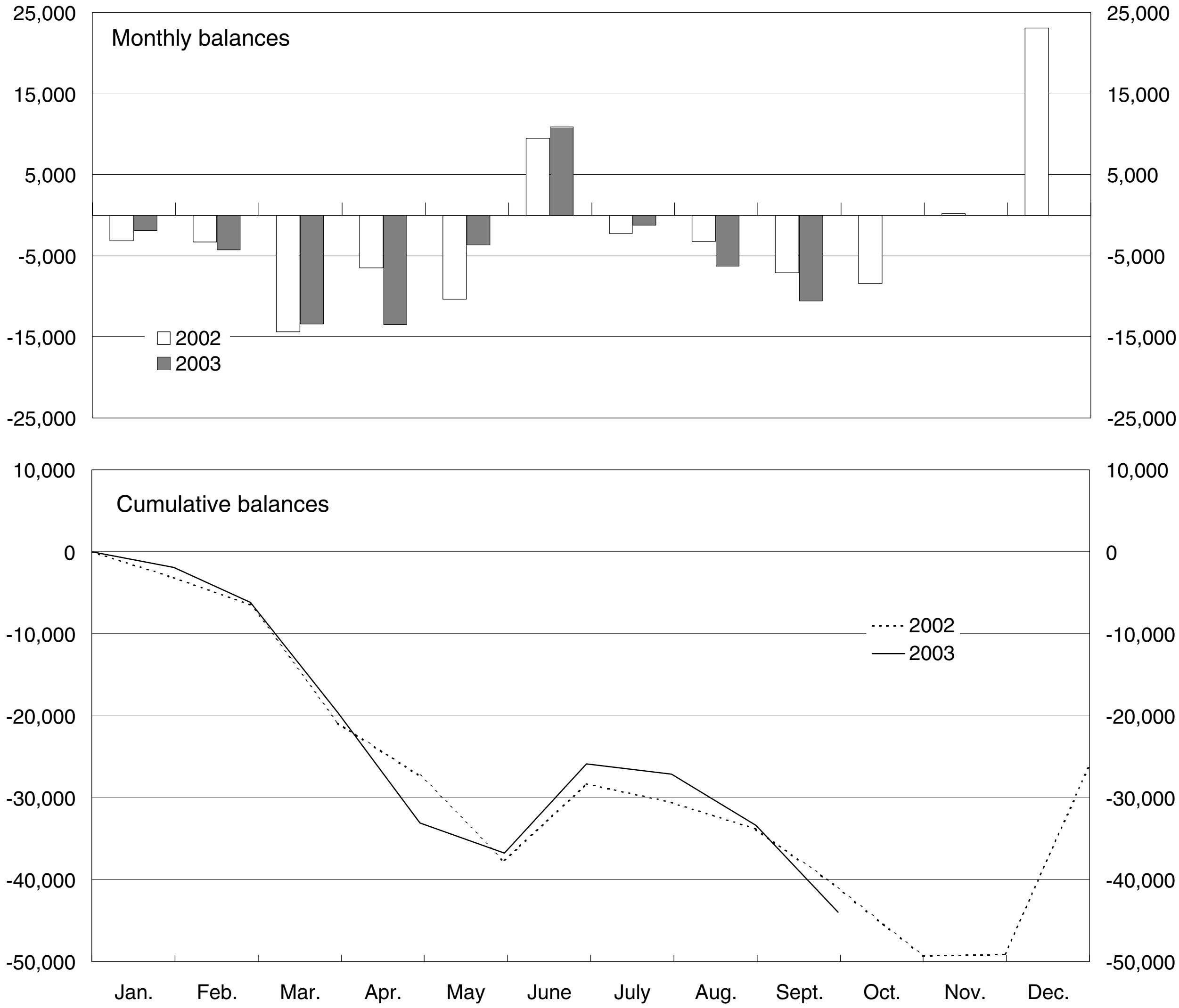


Sources: Based on Istat data and Bank of Italy data for the debt. For the years 2003 and 2004, Update of the Economic and Financial Planning Document for 2004-07.
(1) Excludes the proceeds of UMTS licences. – (2) The figures include the effects of swaps and forward rate agreements.

Figure 2

State sector borrowing requirement in 2002 and 2003 (1)

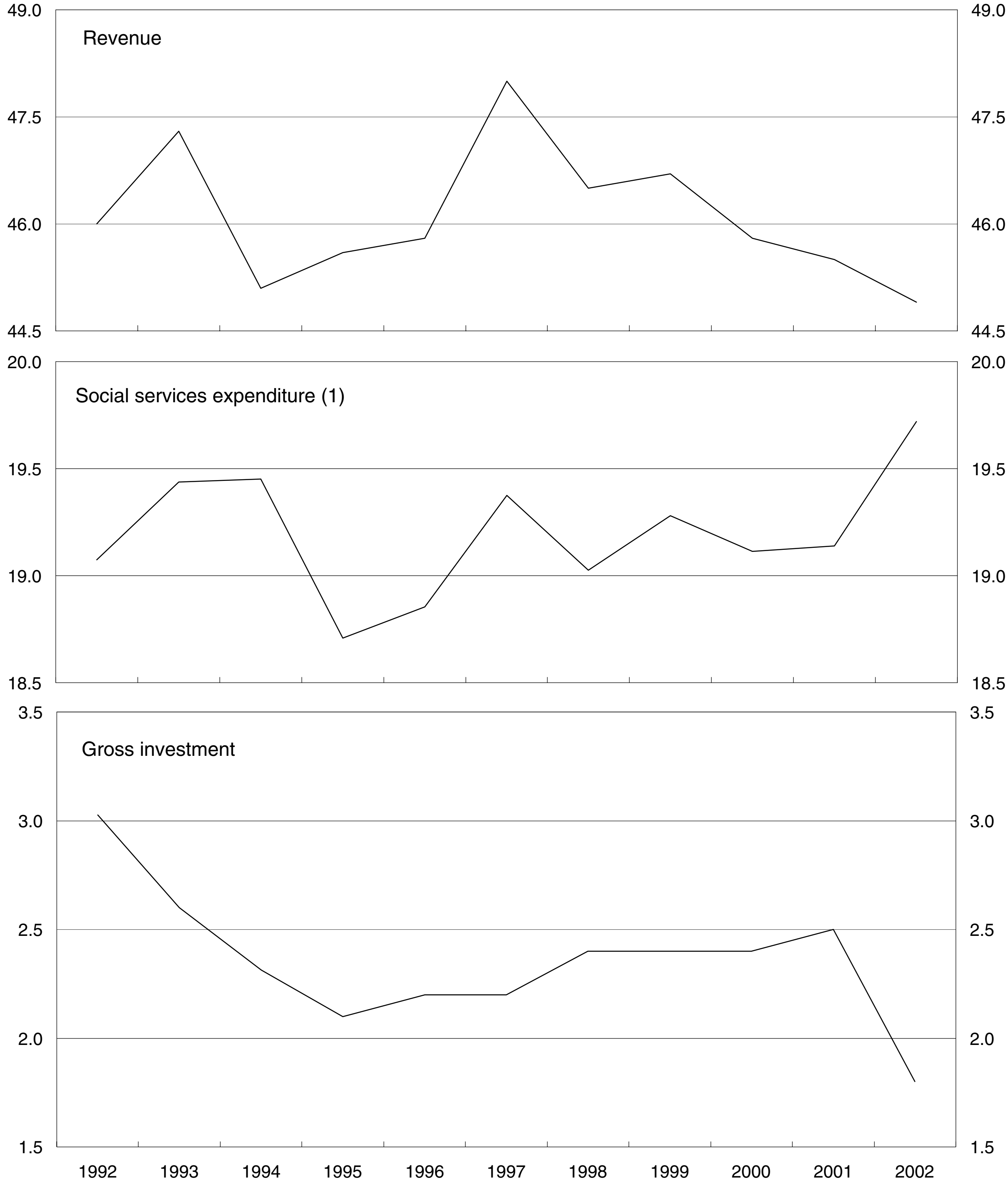
(millions of euros)



(1) Excludes privatization receipts and settlements of past debts. A plus sign indicates a surplus, a minus sign a deficit.

Figure 3

General government revenue, social services expenditure and gross investment
(as a percentage of GDP)



Source: Based on Istat data.
(1) Includes social services in money and in kind.

2003 World Savings Day

Address by Antonio Fazio, Governor of the Bank of Italy, to the ACRI - Association of Italian Savings Banks

Rome, 31 October 2003

1. The international economy

After the stagnation that had lasted from the autumn of 2002 until the spring of this year in connection with the war in Iraq, the world economy entered a new phase of expansion in the summer. From March onwards, as the uncertainty caused by the conflict began to diminish, share indices began to climb and financial indicators to improve.

In the second quarter economic activity gradually picked up in the United States and Asia. US gross domestic product increased by 7.2 per cent on an annual basis in the third quarter and is expected to rise by more than 4 per cent in the fourth. Year on year, growth will be around 3 per cent.

In Japan GDP grew in the second quarter at an annual rate of 3.9 per cent.

In Europe, the stagnation of the first two quarters gave way to still timid signs of recovery in Germany and France, both of which have large industrial sectors.

The dollar appreciated in the summer, reflecting the increased strength of the US economy; the exchange rate climbed back from the low point of 1.19 dollars to the euro at the end of May to 1.08 at the beginning of September. Subsequently, the US currency began to depreciate again and yesterday was close to 1.16 to the euro. Since the middle of September it has also fallen against the yen. Dollar depreciation has adverse effects on the price competitiveness and cyclical performance of European industry.

In the United States labour productivity continues to grow at a rapid pace. The trend has withstood the cyclical slowdown under way since the middle of 2000, testifying to the efficiency of the US productive system.

Consumption accelerated in the third quarter, growing at an annual rate of 6.6 per cent; it benefited from the tax relief measures introduced in May. Private fixed capital investment increased by 14 per cent, making a substantial contribution to the growth in output of over 2 percentage points, which was similar to the figure before the slowdown. Investment in IT, which had been picking up for some time, rose by a further 15.4 per cent. Exports expanded by 9 per cent. The contribution of public spending was virtually nil.

The growth in corporate profits and the sounder financial situation of firms underpin the assumption that a lasting recovery will take place in capital formation.

In Japan economic activity was mainly buoyed by the substantial rise in exports to other Asian countries and the acceleration of investment; the growth in demand attenuated the deflationary trend. The central bank continued to pursue a policy of monetary base expansion and purchased dollars on a massive scale to counter the appreciation of the yen. The improvement in corporate profitability, which also benefited from financial and productive reorganization, suggests that the investment cycle will gather strength in the future.

China's rate of economic growth in the first nine months of the year exceeded 8 per cent in comparison with the same period of the previous year. Imports increased by more than 40 per cent in value and exports by 32 per cent.

The country's exports, more than half of which went to other emerging Asian countries at the beginning of the 1990s, have gradually shifted towards the United States and the European Union, where they have gained market shares. China's economic expansion has boosted the development of other emerging countries in the area and, indirectly, the growth of the world economy; imports from Japan and other industrial economies have also increased.

In Argentina the economic recovery that began last year continued through the first half of 2003. In September the government reached an agreement with the International Monetary Fund on a three-year financial aid programme of $12.5 billion, thus avoiding the need to declare the country insolvent vis-à-vis international institutions.

In Brazil the improvement in the climate of confidence and financial conditions is laying the foundations for a strengthening of production in the last part of the year.

A lasting recovery in international trade, the factor that provided crucial stimulus to the development of the international economy in the 1990s, could be jeopardized by the unsuccessful outcome of the Fifth Meeting of Ministers of the World Trade Organization in Cancún last September. It is necessary to overcome this setback and continue the process of multilateral liberalization begun at Doha in 2001 to the benefit of the poorest countries and the whole international economy.

2. The euro area and Italy

During the first half of 2003 the euro-area economy stagnated.

Gross domestic product, which was stationary in the first quarter, declined by 0.2 per cent on an annual basis in the second. The cyclical weakness extended to all the main countries, although not to the same degree. The decline in output in Germany in the first six months was equal to 0.6 per cent on an annual basis, the largest of the last ten years. In France it was 0.4 per cent. In Italy growth came to a standstill.

In the area as a whole as well as in the main countries the weakness of the economy was linked to the poor performance of exports. With imports showing virtually no change, the fall in exports subtracted 1.6 percentage points from growth in the area.

The increase in domestic demand was buoyed principally by private consumption, which accelerated slightly with respect to the previous six months. Spending on capital goods, which had been falling since the first half of 2001, continued to reflect the large margins of idle capacity and the uncertainty about the timing and strength of the economic recovery.

In Italy in the first half of 2003 the negative contribution of trade to growth was equal to 2.3 percentage points. Domestic demand was sustained largely by inventory rebuilding.

Household consumption performed better than in the rest of the euro area but purchases of durables contracted. Investment in capital equipment declined by 15.2 per cent on an annual basis, partly due to low level of plant utilization and the uncertain outlook for demand.

Expectations for 2004 do not point to an upturn in investment in either industry or services.

According to the business survey conducted in September by the branches of the Bank of Italy among a sample of manufacturing and service companies, expenditure on fixed investment in 2003 will be even less than budgeted at the end of last year, which was already down by about 10 per cent.

Activity in the public works sector is expected to contract slightly again in 2003. Following the rise in the value of works put up for tender at the beginning of the year, there are widespread expectations of an upturn in the first half of 2004.

Exports declined in the first half of the year by 11.4 per cent on an annual basis, considerably more than in Germany or France, where they decreased by respectively 2.7 and 5.5 per cent.

In the first nine months of this year the harmonized consumer price index rose on average by 2.1 per cent in the euro area and 2.9 per cent in Italy.

The rise in the prices of services and costs in industry was largest in Italy. The rate of increase in unit labour costs continues to be higher than that of our European partners. Since wage pressures are limited at present, the rise must be ascribed to the slowdown in productivity.

In the first six months of the year the number of full-time equivalent workers in employment rose by 1.1 per cent from the year-earlier period, compared with an increase of 0.8 per cent in value added.

The decline in per capita output reflects the reduced contribution of technical advances compared with the past, which is evident from the persistent downturn in total factor productivity. It also reflects the expansion in labour intensive and low productivity activities, especially among services provided to businesses and households.

Employment rose by 4.8 per cent in the construction industry and by 2 per cent in private services but remained virtually stationary in the rest of industry and declined again, for structural reasons, in agriculture. The growth in employment during a period of persistently slack economic activity was sustained by the continued moderation of wage demands. The performance in the first half of the year reflected the slow progression of wages fixed in national labour contracts; they are expected to accelerate in the second half of 2003.

Unemployment decreased, in contrast with the tendency in the main European economies. In July the seasonally adjusted unemployment rate was 8.7 per cent in Italy and 8.8 per cent in the euro area. The decrease was concentrated in the South, where unemployment is nonetheless more than three times greater than in the rest of the country.

According to preliminary estimates, industrial production rose in the third quarter by around half a percentage point compared with the second quarter, thus reversing the downward trend under way since last autumn.

However, the upturn is not borne out by estimates for September and October, which point to a fall of over 1.5 per cent with respect to the previous two-month period.

The growth in gross domestic product in 2003 is expected to be less than 0.5 per cent. Since the recovery is still weak at the European level as well, it appears unlikely that a rate of growth of 1.9 per cent can be achieved in 2004.

3. The structure of industry and competitiveness

In the first eight months of the year the performance of Italian exports was negative in all the main markets. Exports to the United States contracted by 13 per cent compared with the same period of 2002, and those to China slowed sharply. Sales to the euro area diminished by 3.1 per cent.

Between the fourth quarter of 2000 and the same quarter of 2002 Italian firms suffered a loss in price competitiveness of 7.5 per cent, which was more than in the other major European countries. Along with the nominal effective appreciation of the euro, a contributory factor was the rise of around 2.5 per cent in the prices charged by Italian exporters compared with those of competitors. The relative prices of German exports remained basically unchanged, while those of French exports diminished slightly.

In the first eight months of this year price competitiveness deteriorated further by 3 per cent. In the same period mechanical engineering was the only sector of Italy's model of specialization to show an increase in the volume of sales.

The modest results achieved of late by Italy's exporting firms are in line with a long-term trend.

Italy's share of world exports at constant prices declined from 4.5 per cent in 1995 to 3.6 per cent in 2002, a proportion similar to that of the mid-1960s. The rapid rise in Germany's sales abroad from 1995 onwards led to an increase in its share of the world market of more than 1 percentage point, to 11.3 per cent in 2002. France's share was stable at around 5.6 per cent.

Italy, which ranked sixth in world trade in the mid-1990s, now ranks eighth, having been overtaken by China and Canada.

Losses of market share have also occurred in the domestic market. However, the differential between the growth in imports and the growth in GDP in Italy is not significantly different from that in the other main European economies.

The disappointing results in both international and domestic markets are attributable to three factors: the composition of output, which in Italy is still heavily biased towards scantily innovative sectors; the unfavourable dynamic of domestic costs and productivity; and the entry into the international market of firms operating in Italy's sectors of specialization and located in developing countries, where production costs are lower, productivity is rapidly rising and the quality of products steadily improving.

Over the last seven years industrial production grew by a total of 4.9 per cent in Italy, compared with 16.4 per cent in France and 16.5 per cent in Germany. In the euro area excluding Italy industrial production expanded by 20 per cent. Only the United Kingdom, where output is oriented towards internationally traded services, recorded a smaller increase in industrial production: 2.5 per cent.

Signs are emerging that Italy is lagging behind the most advanced countries in the shift to a primarily service-based economy. Services' share of total value added has remained virtually unchanged from the end of the last decade, standing at 68.4 per cent in 2002.

By contrast, the service sector's share has continued to grow in the other leading European countries. In Germany and the United Kingdom it rose by seven percentage points between 1990 and 2002, to respectively 71 and 72 per cent. In France it stabilized at around 71 per cent in the second half of the 1990s.

The composition of international demand has shifted towards higher-tech products; in the last ten years world demand for these goods has grown practically twice as fast as that for traditional goods. Between 1997 and 2002 world exports of chemical, electronic and IT products grew by 24 per cent, those of motor vehicles by 24 per cent and other transport equipment by 22 per cent. By contrast, world imports of textile products grew by only 1.3 per cent and those of leather and footwear by 0.9 per cent.

While in the other main European countries traditional branches of production are being abandoned in favour of more innovative ones, in Italy the output of high-tech sectors has contracted, albeit slightly.

In the manufacturing sector total factor productivity diminished by 0.2 percentage points a year between 1995 and 2001. The more intense contribution of capital and labour was not matched by an advance in techniques or organizational efficiency.

The scant growth in productivity is largely attributable to the fragmentation of Italy's productive system. The small average size of firms emerges from the results of all the industrial censuses, the average number of workers per firm has fallen uninterruptedly since 1971, to stand at 3.9 workers per local production unit in 2001.

Small firms are a vital strength of the Italian economy; their flexibility has enabled our country to overcome moments of great difficulty. In the present context, however, they are unable to expand their activity and to compete successfully in the advanced markets.

Competitiveness is affected by factors external to the firm, such as energy costs and the endowment of modern infrastructure. The efficiency of the legal and institutional system also considerably influences the functioning of a market economy. Company law has been reformed in Italy but shortcomings are still to be found, especially as regards bankruptcy law.

It is necessary to remove the obstacles to the growth of firms, first of all by favouring alliances, mergers and acquisitions between companies operating in similar or complementary branches of production. It is a field of activity in which Italian banks can play a role of prime importance.

At the same time it is necessary to establish the conditions for a wider application of the new technologies in industry and the service sector, by creating networks that can raise the productivity of individual firms and, above all, that of the economy as a whole.

Growth in the size of firms, greater investment in research, stimuli to the internationalization of the productive system, investment in infrastructure, and efficiency gains in public and private services are the key points of a strategy for the competitiveness of the productive system and for stronger growth.

4. Interest rates and credit

Short-term interest rates in euros came down by about 0.7 percentage points in the first half of the year, stabilizing at around 2.1 per cent. This is one of the lowest levels since the 1940s.

After falling to historic lows in the first two quarters of the year, long-term rates rose rapidly over the summer, reflecting above all the improvement in the prospects for world economic recovery; the rise was sharper in the United States, less pronounced in the euro area.

The Italian banking system has continued to satisfy the demand for financing for current production and investment. In the first nine months of the year the growth in lending to residents accelerated by comparison with the previous year, owing to the rapid expansion in the medium and long-term component. The increase amounted to 7.7 per cent in the twelve months ending in September, higher than the average in the euro area.

The credit expansion involved both non-financial firms and producer households; it was greatest for those in the service sector and the construction industry. Lending to manufacturing firms, which had contracted in 2002, showed a moderate increase on the order of 5 per cent.

There was a slowdown in lending to large companies but an acceleration in that to small and medium-sized firms with credit lines of up to €25 million.

Credit to consumer households has continued to expand rapidly, growing by 9.1 per cent in the twelve months ending in August, primarily in the form of mortgage loans for the purchase of housing.

The growth in credit has been broadly similar throughout Italy. Adjusted for the effects of bank consolidations, the average annual growth in lending in the South by banks based in the Centre and North amounted to 9.7 per cent between 1998 and 2002, around eight percentage points more than in the previous five years.

Banking groups based in the Centre and North are allocating a growing portion of the funds they raise in the South to southern businesses; in June the percentage exceeded 90 per cent, compared with 60 per cent for the remaining intermediaries.

Bank lending rates have fallen, adjusting gradually to money market conditions, in line with the euro-area average. In the first nine months of the year the average rate on short-term loans to non-bank customers fell by 0.9 percentage points to 4.8 per cent. Taking account of the different composition of firms by size and sector, the differential between short-term bank lending rates for firms in the South and those in the Centre and North widened slightly to 1.1 points; the increase corresponded to a higher rate of growth in new bad debts in the South.

5. The growth of the corporate bond market

In a phase characterized by low real interest rates, an international bond market for euro-area firms has developed rapidly since the introduction of the single currency.

Between 1998 and 2002 the stock of bonds issued by banks and firms grew from 44 to 59 per cent of the area's GDP, a figure comparable to that prevailing in the United States if the securities of government agencies are excluded.

In the four years from 1999 to 2002 Italian non-financial corporations made an average of 43 bond issues a year, with an average issue value of €440 million. In the four previous years issues had numbered 11 per year, with an average value of €150 million per issue.

The transactions were carried out largely in Luxembourg, because of the speed and low costs of the procedures and lower taxation.

Since the spring of 2000 the slowdown of the world economy has brought an increase in the risk premium on corporate bonds in all the main countries. The deterioration in corporate situations has led to a growing number of defaults, first in the United States, then in Europe.

In 2002 there were 32 defaults on securities of European non-financial corporations. Half of the companies unable to honour their debts were British and a quarter were Dutch; three cases of default occurred in Germany and one case each in Italy, France, Belgium, Switzerland, Sweden and Norway.

The default in Italy concerned the bonds of a food products group that had made issues for a total of €1,125 million, or about 1.5 per cent of the bonds issued by Italian non-financial companies in Luxembourg between 1998 and June 2003.

As with most Euromarket bond issues, the securities were sold by the underwriting syndicates to banks and institutional investors. Some were subsequently bought by individuals in transactions with banks. Demand for the bonds was boosted by their high yields in comparison with those offered by issuers with the lowest investment grade ratings.

In Italy the number of individuals who bought these bonds by means of bilateral contracts with banks averaged about 4,000 per issue; the sale prices varied from bank to bank and moved in line with market conditions. Public offerings, which require the preparation of a prospectus, are aimed at a large number of anonymous investors and marked by a single price for the entire offering period.

In selling securities, banks are subject to the rules of conduct established for the solicitation of investors and the marketing of financial instruments.

The investigations undertaken by Consob and, at its request, by the Bank of Italy are at an advanced stage. They will make it possible to trace the paths taken by the bonds, from the time they were issued to the time they were acquired by customers, and to assess the actions of the individual intermediaries. If violations of the rules and regulations are found, the necessary steps will be taken in the competent fora.

The distinction between a bank deposit and a bond issued by a company or a public entity is fundamental and savers need to be reminded of it. Only in the former case is the bank under an obligation to redeem the principal. Over many decades, from the 1930s onwards, no Italian savers have ever incurred losses on their deposits.

The bonds issued by a company or a public entity, and sometimes even a sovereign state, normally offer a higher yield, to compensate for the risk implicit in such instruments.

This risk is primarily related to the financial situation of the issuer. As in the other advanced financial systems, the checks required by law do not include evaluations of the economic advantageousness of the securities that are being offered or of the solvency of the issuer.

It is up to the intermediaries that buy bond issues and then place them with institutional investors or individuals to evaluate the quality of the securities and the adequacy of the yield.

The intermediaries responsible for the marketing of securities must be fully aware of the nature of the risk and make it clear to investors, in accordance with the regulations established by Consob.

The preliminary findings with respect to a sample of transactions concluded by the intermediaries inspected by the Bank of Italy show that most of the bond sales examined were carried out in compliance with the provisions designed to ensure the necessary transparency in dealings with customers and to prevent the proposal of transactions unsuited to investors.

Where internal checks reveal cases in which the procedures prescribed by law were not complied with completely, the individual banks concerned will assess the desirability of taking steps to strengthen the confidence of investors and maintain their reputations.

6. Conclusions and prospects

Doubts about the efficiency and integrity of a part of Italy's financial system may be counterproductive for the development of the markets and ultimately for the business of firms, which are already having to cope with a weak economic cycle.

From a macroeconomic point of view, the defaults that have occurred in Italy have been on a smaller scale than those in the other leading industrial countries; the value of corporate bonds exposed to the risk of losses is less than 0.05 per cent of households' total financial assets.

A large share of the savings of firms and households consists of bank deposits. At present households' total financial assets comprise €480 billion of such deposits and €2,100 billion of other financial assets.

Bank deposits, together with government securities, are safe investments for savers; they consequently offer lower rates of return. Deposits tend to grow in line with gross domestic product; other financial instruments grow at a much faster pace.

In all the world's developed economies the activity of banks has spread during the last ten years or so to include the distribution to savers of financial instruments such as bonds and shares, thereby fostering the consolidation of firms' financial structures and the diversification of households' portfolios.

I reiterate what I have already stressed on other occasions. In this activity the professionalism of intermediaries must always be coupled with ethics, so that savers are directed towards investments that are consistent with their income, wealth and appetite for risk.

The organizational and operational structure of each intermediary must be capable of performing this task correctly.

The protection of savings is enshrined in the Constitution. The Bank of Italy is responsible for the stability of the banking system and for the protection of the savings this intermediates directly. History shows that this kind of investment has been fully guaranteed without interruption from the enactment of the 1936 Banking Law up to today.

A sound and efficient banking system is essential for the stability of the economy, especially when business activity is sluggish, as at present, and also an instrument for the support of productive investment and economic growth.

The stability of the financial system is based on the solidity of the economy and the profitability of firms.

Overcoming the problems the Italian economy faces today depends basically on economic policy measures capable of accelerating growth through a higher level of investment activity.

At a time when there is the prospect of an international recovery, it is up to economic policy to create the conditions for faster growth, but ultimately it is up to firms to take investment decisions, on the basis of their ability to foresee and plan the future, search for new markets, and introduce new technologies and products.

For nearly ten years now the Italian economy has been suffering from a steady loss of competitiveness that slows its growth and endangers less efficient and innovative firms.

Much has been done in terms of improving the efficiency of the money and financial markets, from the 1980s onwards, and restructuring the banking system, since the mid-1990s; there has been a considerable increase in competition. Credit and finance are necessary to arrive at a more efficient working of the economy, but they are not sufficient to ensure its growth.

In the past a very high proportion of savings was absorbed by the public sector. Budgetary equilibrium is a key prerequisite for the creation of a climate conducive to the expansion of investment; to achieve this goal, it is necessary to curb the growth of primary current expenditure through structural reforms in the main sectors.

The tax burden, which increased considerably between the second half of the 1980s and the second half of the 1990s in order to reduce the budget deficit, has had deleterious effects on competitiveness and the productive structure. General government net borrowing, which in 1999 had fallen to 1.7 per cent of GDP, has begun to rise again; the reduction in the public debt in relation to GDP has slowed.

Participation in the single currency has ensured that the financial system has enjoyed much more stable conditions than in the past. For growth to benefit, this step needed and needs to be accompanied by a complete and lasting adjustment of the public finances and an increase in the effectiveness and efficiency of government services. Important advances have been made in the organization of the labour market.

The convinced participation of the social partners is an essential prerequisite for a project that will enable Italy to return to growth.

One has the impression of a country, an economy that is not fully exploiting its potential.

A lessening of the tax burden requires a reduction in current public expenditure, not in absolute terms but in relation to GDP.

The endowment of infrastructure falls short of that necessary for competitiveness and growth, both in the more economically advanced regions and in those that are less developed.

The share of expenditure devoted to infrastructure contracted sharply during the 1990s; it remains small, especially in relation to the need to close the gap with respect to the other advanced economies.

In an international setting marked by the availability of abundant finance at low interest rates, public investment is not held back so much by a lack of funds as by delays in drawing up plans and administrative constraints that obstruct their implementation.

Considerable efforts are being made in this field, but they need to produce results as soon as possible.

We continue to take an optimistic view, based on objective data such as Italians' high propensity to save, of the scope for the economy to grow. Following the decision of the Constitutional Court, banking foundations can better undertake new initiatives and contribute to the development of our society. We must proceed resolutely to ensure dignified employment for the still excessively large number of those who could work but do not enter the labour market for want of job openings.

We must proceed in this direction in order to leave the next generation a country that is economically and socially more advanced, that can give effect to the dictate of the first article of the Constitution: "Italy is a democratic republic, founded on work".

The Italian economy: a problem of growth (*)

Speech by Pierluigi Ciocca, Deputy Director General of the Bank of Italy, to the 44th Annual Meeting of the "Società Italiana degli Economisti"

Salerno, 25 October 2003

A mediocre performance. – Italy's economy experienced "miraculous" growth, expanding at a lively pace from the end of the Second World War until the early 1970s.[1] Since then a tendency to slow down has prevailed. This is apparent in all the indicators: GDP (total and per capita, effective and potential), consumption, productivity and exports (Tables 1 and 2).[2] Compared with the past, and with economies that have a larger service sector, the results have been particularly disappointing in the decade following the rupture caused by the 1992 foreign exchange crisis. From the first quarter of 2001 through the second quarter of 2003 economic activity expanded hardly at all: the most protracted stagnation in half a century.

Rectification of Italy's historical lag in development, wage and oil shocks, public sector imbalances and macroeconomic instability are, at least *prima facie*, explanations of the slowdown of the 1970s and 1980s. It is less easy to explain the poor performance afterwards, recommend economic policies and courses of conduct, and hazard medium-term forecasts.

The economic question facing Italian society has returned in all its gravity and all its profundity as a *problem of growth*. Obviously, the issues are why this has happened and what can be done. Given the nature of the problem – long-term dynamics – attention must be focused above all on the supply side.[3]

Five families of variables – combined differently in each theory and for the most part empirically tested – complete, or nearly, the taxonomy of the possible, strictly economic determinants of growth:

- morphology of the economy: entrepreneurship and enterprises; saving/investment; technology, R&D, capacity to innovate; quality and quantity of the workforce; external openness; financial system; relative prices; functional, personal and geographical distribution of income and wealth;
- infrastructure: material (power, water supply, transport, communications, networks) and juridical-institutional, administrative and above all private law (commercial, company, bankruptcy and labour law and civil procedure, all of which are components of a market economy);
- incentives for producers: competitive stimuli in the dynamic sense, both macro (exchange rate, wages, public spending) and micro (competition in product and factor markets, contestability of corporate ownership and control, antitrust action);
- international context: the development of world trade, changes in comparative advantages and in the terms of trade;
- macroeconomic framework: money and public finance; prices and interest rates; real and financial stability.

The questions facing post-1992 Italy can be tackled in three steps:

- identifying, within each family of determinants, those that have deteriorated with respect to pre-1992 levels or trends;

(*) *The author wishes to thank Guido Rey and the economists of the Bank of Italy for their help in preparing this summary: Fabrizio Balassone, Andrea Brandolini, Matteo Bugamelli, Alberto Locarno, Marco Magnani, Salvatore Rossi, Sandro Trento, Ignazio Visco and Francesco Zollino.*

Table 1

Average annual growth rates of GDP and per capita GDP
(percentages)

	1951-1972		1973-1982		1983-1992		1993-2002		2001-2003	
	GDP	GDP/POP	GDP	GDP/POP	GDP	GDP/POP	GDP	GDP/POP	GDP	GDP/POP
Italy	5.3 (1)	4.6 (1)	3.2	2.8	2.3	2.3	1.6	1.4	0.9	0.7
United States	3.9	2.4	2.4	1.3	3.4	2.4	3.2	2.0	1.8	0.7
Canada	4.9	2.6	3.2	1.9	2.7	1.5	3.4	2.4	2.4	1.4
United Kingdom	2.8	2.3	1.4	1.4	2.5	2.2	2.7	2.3	1.9	1.5
France	5.0	4.0	2.7	2.1	2.2	1.7	2.0	1.5	1.3	0.8
Germany	5.7	5.1	2.0	2.0	2.1	1.8	1.3	1.1	0.3	0.2
Japan	9.4	8.1	3.8	2.7	3.9	3.4	1.0	0.7	0.9	0.7
EU	4.8	4.0	2.3	1.9	2.4	2.0	2.1	1.8	1.2	1.1
OECD	4.8	3.7	2.6	1.9	3.0	2.4	2.6	1.8	1.4	0.9
World	4.8	2.9	3.2	1.4	3.1	2.2	3.3	2.5	2.9	2.0

Sources: A. Maddison, *The World Economy* (2001); IMF, *World Economic Outlook* (September 2003); for Italy, Prometeia and Istat.
(1) 1952-1972.

- assessing their "contribution" to the slowdown in the light of the magnitude of the deviation and what econometric analyses can tell us about the effect on growth;
- formulating measures – by government, business and unions – affecting not only the variables that have acted as a brake on the economy but also others, to ensure they provide as strong an impetus as they have since 1992.

It should be emphasized that the following analysis focuses on the *trend* of growth: on the performance of the Italian economy over time and compared with the past rather than with the trend in other countries. Although the two planes are connected they should not be confused.

The main problems: productivity and exports. – Growth accounting for the past decade indicates that the slowdown in per capita GDP (compared with the previous decade) was caused by the decrease both in the contribution of labour and in the growth of labour productivity. The slower rise in the latter – which nevertheless remains quite high – depended more on decreased growth in total factor productivity (weaker in terms of unincorporated technical progress and production organization) than on decelerating capital intensity. This all points to an economy that is structurally less capable of employing labour efficiently, innovating, applying technical advances, competing. What is most worrying is the decline – down to the negative values recorded during the unfavourable economic conditions of recent years – in the growth of labour productivity (see also Table 3) and total productivity growth. The latter slowed in most sectors.

On the aggregate demand side the slowdown has been most apparent in the reduced contribution of private and public consumption, which net exports have been insufficient to offset.[4] Exports are a potentially inexhaustible source of demand and therefore also an important indicator of the economy's capacity to produce high quality goods at low prices. It is alarming that Italy's exports have visibly lost shares of the world market after growing almost without a break from the end of "autarky" in the 1940s to the early 1990s.[5] The limitation of the "made in Italy" tag is the high price of the goods. It is also the quality, the type of goods and the persistently old model of specialization. Italian exporters appear less able to respond to changes in comparative advantages by renewing their products and reallocating resources.[6] At the same time – according to the statistics – the production of Italian firms abroad has not yet become a viable replacement for exports.[7]

Table 2

Indicators of Italian economic growth
(average annual percentage changes)

	1983-1992	1993-2002	2001-2003
GDP	2.3	1.6	0.9
Employment (standard labour units)	0.6	0.3	1.3
Per capita GDP	2.3	1.4	0.7
Labour productivity	1.8	1.3	-0.5
Employment rate	0.5	0.1	1.2
Potential GDP	2.3	1.7	1.8
Value added at factor cost (1)	2.3	1.8	1.0
Contribution of capital stock	0.7	0.6	0.7
Contribution of labour input	0.4	0.2	0.9
Total factor productivity	1.2	1.0 (2)	-0.6
Labour productivity (3)	1.7	1.5	-0.3
Total factor productivity	1.2	1.0	-0.6
Capital intensity	0.5	0.5	0.3
Per capita consumption	2.9	1.2	1.2
Exports of goods and services	4.7	5.3	-0.8
(World trade)	5.4	6.5	2.1

Sources: Based on Istat, OECD and IMF data; estimates for 2003.
(1) Net of the rental of buildings. – (2) 1.4 in 1991-1995, 0.6 in 1996-2002. – (3) Differs from the preceding estimate because it is calculated on value added at factor cost rather than on GDP.

Factors of growth despite everything. – Some factors, far from producing unsatisfactory results over the past decade, have actually contributed to growth, preventing a more pronounced slide.

a) Capital formation, despite a slight decline in volume, has improved considerably as regards composition over the decade.[8] On the whole it has not impeded the development of the economy and remains the fundamental determinant of growth. Nevertheless, there has been no leap in investment – notably in R&D – even though funds were available. With the end of the recession of 1992-1993 the share of national income going to profits, the rate of profit on invested capital and the return on corporate assets all increased, rising to levels that were higher, on the average, than in the years before the recession. The financial condition of firms improved at the same time, as their debt ratio and the cost of debt service both declined (Table 4, Figure 1).[9] These tendencies were most pronounced in the service sector (about 70 per cent of the Italian economy). Variations in entrepreneurship cannot be measured. But clearly what prevailed was prudence, the consolidation of positions, an attitude of business as usual.[10]

b) Though remaining far behind other countries, Italy has continued to improve the education of its work force and of the population at large. In the 1990s the average number of years of schooling rose from 9 to 11, after rising from 7½ to 9 in the 1980s. The share of secondary school and university graduates in the work force increased sharply, both among the youngest age-groups and among the less young. Other indicators – audiovisual equipment, computers, foreign language proficiency, travel abroad, books published – confirm that in the course of the last decade human capital has continued to accumulate.

c) The Italian economy has grown more open. This development – highly positive for its input of technical progress and competition, even beyond the sectors of internationally traded goods – involved both trade in goods and services and financial transactions.[11] All foreign exchange restrictions were removed at the end of the 1980s. Italian manufacturing is not among those most strongly protected, *de facto* or *de jure*, by tariff and non-tariff barriers, despite the extremely serious problem of unfair competition from countries that violate world trade rules.

d) The financial system has undergone a profound, if slow and difficult, mutation, a true metamorphosis that began in the early 1980s and gradually gathered momentum, with a marked acceleration in recent years. This process has brought the Italian banking and financial industry, even in the South, more closely into line with the other leading countries. Overall, there has been an appreciable improvement. *Ceteris paribus*, structural changes fostering capital formation and allocative efficiency are estimated to have raised the average annual rate of per capita

Table 3

Labour productivity in Italy

(average annual percentage changes)

	1983-1992	1993-2002	2001-2003
GDP per employed person	1.6	1.2	-0.6
GDP per standard labour unit	1.8	1.3	-0.5
Value added at factor cost per standard labour unit			
– Total economy	1.8	1.4	-0.3
– Total economy (net of rental of buildings)	1.7	1.5	-0.3
– Private sector (net of rental of buildings)	2.3	1.8	-0.4
– Private services (net of rental of buildings)	0.9	1.6	-0.6
– Industry excluding construction	3.3	1.7	0.1
Value added at factor cost per hour of work in industry	2.8	1.9	0.6

Sources: Based on Istat and Invind data; estimates for 2003.

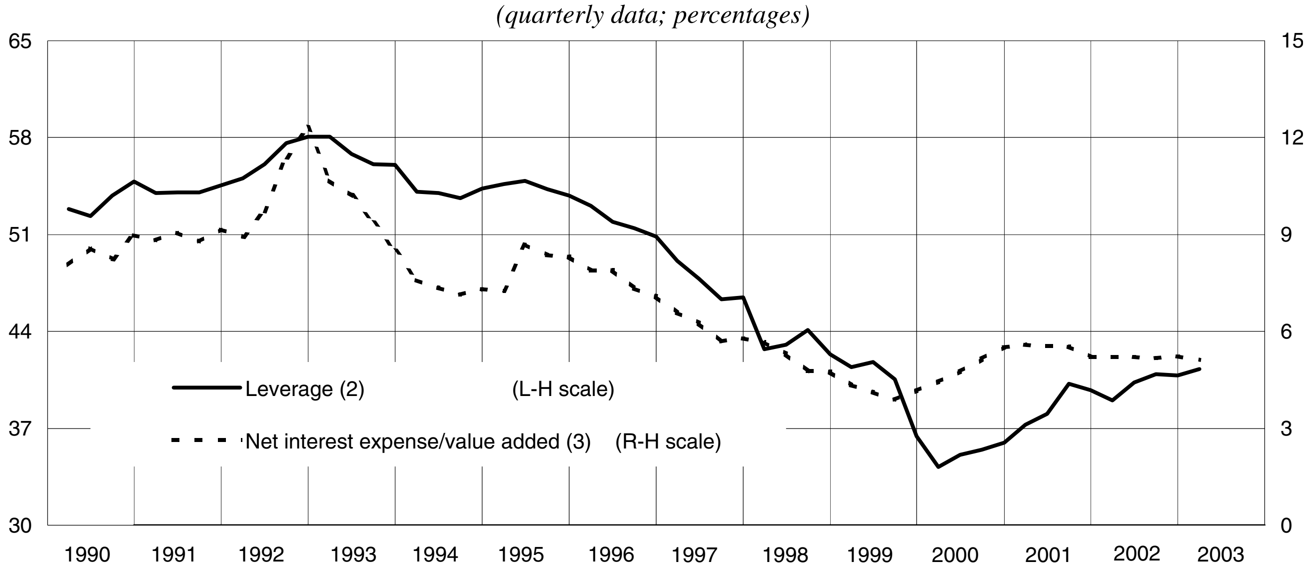
output growth by 0.3 percentage points in the past 10 to 15 years.[12]

e) All in all, the macroeconomic framework has achieved a better balance. Monetary policy was joined by more rigorous management of the public finances and of nominal incomes. Despite the currency crisis of September 1992 – and then that of March 1995 – the Italian economy avoided the abyss of instability. The good of price stability was recovered after a quarter of a century and then locked in through Italy's participation in the single currency. From every point of view – monetary, financial, foreign-exchange – the decade increased the scope for economic growth.[13] It bears reiteration that the underlying growth trend of economic

Figure 1

Debt and interest expense of Italian firms (1)

(quarterly data; percentages)



(1) See Table 4.

activity, beyond the short period, was slowed little if at all by the reduction of the budget deficit following 1992 and by the successful disinflationary monetary policy of the Bank of Italy from 1994 to 1998.[14]

Table 4

Debt and interest expense of Italian firms (1)

(annual data; percentages)

	Leverage (2)	Net interest expense/ value added (3)
1990	54.82	8.97
1991	54.55	9.16
1992	58.05	12.32
1993	56.03	8.48
1994	54.32	7.32
1995	53.82	8.32
1996	50.83	7.09
1997	46.48	5.79
1998	42.32	4.75
1999	36.41	4.16
2000	35.97	5.51
2001	39.74	5.22
2002	40.82	5.24
Q1 – 2003	41.26	5.11

Sources: Financial accounts, Istat.
(1) The data are for "non-financial firms" and from 1995 onwards refer to the new definitions of financial instruments and sectors of economic activity introduced by ESA95.– (2) Leverage is calculated as the ratio of financial debt to the sum of financial debt and equity. – (3) Estimate of the value added of "non-financial" firms based on the institutional accounts and national accounts compiled by Istat.

The relationship between growth and the labour market remains an open question. In ex post growth accounting, the slowdown in per capita output also reflects a smaller contribution of labour and decreasing labour intensity. At the same time, unutilized human resources were abundant (Table 5).[15] Comparative statistics show that relatively few Italians work and that those who do, work "little". Given the level of labour productivity – which corresponds to a large endowment of capital per worker – the lesser utilization of labour lowers Italy's rank in terms of GDP per inhabitant. But this affects the level of economic activity rather than the trend growth rate. Growth is hardly fostered by a labour market and industrial relations that impede the reallocation of resources – capital as well as human – in response to changing relative prices and comparative advantages. By the conventional standards of contemporary labour economics, Italy continues to have "one of the 'worst' labour markets in Europe".[16] This has several adverse effects, especially when Italy is compared with the rest of Europe. However, in itself it is less important for the analysis of the slower growth of the last decade.

The last decade has seen an epochal change in Italian society: the beginnings of large-scale immigration. Among other things, this has created more freedom in the utilization of labour, dramatically increasing flexibility in the labour market and in employment relationships. Labour market institutions have not deteriorated further. Indeed, in some respects they actually improved towards the end of the decade.[17] Real wage growth slowed, more than in the 1980s and more than productivity.[18] For companies, this at least partly compensated for the institutional shortcomings of the labour market. Other things being equal, it limited the overall decline in the demand for labour, which was responsible for the decline in labour-intensiveness in the economy for the decade. In contrast with past periods, wages are not now among the main problems of the Italian economy. Nominal earnings are higher in the North – where the same labour legislation as in the rest of the country is in effect, but with full employment – even though they are not high enough to induce substantial internal migration. In other respects labour is not immobile.[19] Mobility is uncertain and costly, and the conditions – legal conditions, but also housing, services, social acceptance of immigrants and migrants in general – can be improved. The institutional progress and the low relative cost of labour were responsible for the upturn in employment after 1996, with the anomaly of a statistically very high *ex post* elasticity of employment to GDP in recent years (partly the result of the "emergence" of underground labour).

Factors of stagnation. **–** From the classification of the causes of growth recalled at the outset, almost by exclusion the following appear to be the proximate causes of stagnation.

Table 5

Italian labour market indicators

(percentages; annual averages)

	1983-1992	1993-2002	2001-2003
Unemployment rate	9.2	10.8	9.1
Participation rate (persons aged 15-64)	58.9	58.8	60.9
Employment rate (persons aged 15-64)	53.5	52.3	55.3
Incidence of underground work	–	14.7 (1)	15.3 (1)
Annual population growth rate	0.1	0.2	0.2
Composition of the population			
0-14 years	18.0	14.7	14.2
15-64 years	68.0	68.0	67.2
65+ years	14.0	17.3	18.6
Immigrants/population	–	1.8 (1)	2.5 (1)
Annual hours of work in manufacturing industry (number)	1.637	1.676	1.656

Sources: Based on Istat and Invind data; estimates for 2003.
(1) Data up to 2001.

1) Italy's very high public debt, the extremely burdensome legacy of a long period of political and financial irresponsibility that led to its more than doubling between 1981 and 1995, when it rose from 60 to 125 per cent of GDP.[20] In various ways the public debt has represented and continues to represent an impediment to faster capital accumulation, hence to growth. In the past the obstacle consisted in part in the risk premium inherent in the high cost of money, which curbed investment. In more recent years the brakes have been applied by expectations that depress the propensity to invest. From entrepreneurs' viewpoint the reduction in taxes – which were raised rapidly until 1997[21] – has come to seem less and less likely, even in the medium term. There are scant budgetary resources to maintain and upgrade an infrastructural endowment that is less and less adequate and to reduce the cost of labour for firms.[22] These are two additional consequences relating to the still precarious state of the public finances that have a negative impact on growth. At the very best, the disparity vis-à-vis Italy's European competitors in three crucial areas – taxation, infrastructure, social contribution costs – is not expected to widen further. The long-term expectations of Italian businessmen, who are now bound by the irrevocably fixed exchange rate with other euro-area producers, are that the gap is unlikely to be narrowed.

2) The backwardness of Italy's infrastructure, now acute and palpable. Especially inadequate in the South, tangible infrastructure, whose maintenance and modernization is very costly first of all for the public finances, has not been strengthened in Italy as a whole; it has probably deteriorated. It has not matched the growing needs. Italy's endowment of tangible infrastructure has not measured up to the quantitative and qualitative standards of the other European countries and risks continuing to fall short.[23] Moreover, the same is true of important components of intangible infrastructure. The economy's legal order, which is crucial for growth, has proven increasingly less suitable as regards both legislation and its application. This holds for company law, bankruptcy law, civil procedure and some aspects of labour law. Though in themselves they "cost nothing", reforms in this field too have made slow headway. A new version of company law, whose civil-law elements are noteworthy, will enter into force in 2004. Yet attaining the overall vision needed to forge a new, organic framework of company law is hindered by the insufficient connections of economic culture with legal culture and by vested interests.[24]

3) Both the fragmentation of enterprise and the inability of small firms to grow – historical

features of Italian capitalism – have grown more accentuated.[25] The reasons are partly legal, bureaucratic and tax-related; Italian firms find it "in their interest" to stay small, in order to contain costs and risks. Unfortunately, this has coincided with the age of digital technology, ICT and electronics, technical advances whose potential to bestow greater flexibility can be exploited especially by large companies engaging in mass production.[26] Far from being imposed by the model of specialization, Italian firms' failure to grow perpetuates that model, restricts investment abroad and limits exports.[27] There is ample evidence of the impediments this creates for the training of workers, investment in research, technical progress (especially in ICT) and productivity.[28] In the relationship between the swarm of tiny companies and the few surviving large corporations there is a lack of complementarity in research and an insufficient osmosis of innovations.[29]

4) Despite international openness, competition in its broadest sense has diminished overall in the Italian economy. It has diminished both at the level of macro determinants (the exchange rate, real wages, public spending) and at that of micro determinants (in product markets and in the market for corporate ownership and control). The support of public spending, the scope for currency depreciation and the accommodating dynamic of wages have weakened the stimuli to efficiency and innovation that can overcome laxity and moral hazard on the part of producers. In the last ten years primary public expenditure has been high (42-43 per cent of GDP, as in the 1980s), the exchange rate lax (first for the lira and then for the euro up to the start of 2002), the growth in real wages slow. In the market for corporate ownership and control the contestability of existing structures has been toned down by the high incidence of majority ownership by the largest shareholder, particularly as firm size decreases. In the goods markets the indices of oligopoly (Lerner indices) have risen on average to 19 per cent, from 15-16 per cent in the 1970s and 1980s; the decline in competition has been principally in services other than banking and financial intermediation.[30] The 1990 antitrust law mainly prescribes a static type of protection for consumers who file complaints of understandings in restraint of trade or abuses of dominant position in the goods markets to which final demand is directed. Contrary to what the dynamic conception of competition as the engine of economy-wide growth would require, it lays less stress on promoting competition in the markets for "basic products", which play a direct or indirect role in the production of all other goods. These are the key industries. Their competitive tenor is decisive for the allocation of resources over time, for the leveling of profit rates across products, for the growth of the economy. The scaling down of public enterprise, as opposed to its correct and efficient management, has itself removed an alternative to private enterprise, a potential competitor. In some fields it has led to actual or potential quasi-rents for private enterprises. The foregoing observations are succinctly confirmed by the disjunction between the Italian economy's high profit rate and low growth rate in the last ten years. On the whole producers have not perceived a more intensely competitive climate, one spurring them to capital mobility, productivity, lower costs and innovation.

Two last remarks will complete the picture. First, at the international level the changes in comparative advantages, together with the opportunities for access to potentially vast outlet markets, have constituted specific risks for the existing structures of Italy's productive system. On the one hand there is the rise of new trading partners (China and India after the "Asian tigers", for example) that tend to export the consumer goods Italy produces and to import capital goods Italy does not produce; on the other there has been a strengthening of economies, such as that of the United States, which tend to supply products – consumer and producer goods and services – characterized by economies of scale, R&D and innovation. Italy's model of specialization has therefore become "vulnerable from above and below".[31]

The second remark concerns the accentuation of inequality in the personal and geographical distribution of income, which was already greater than in other industrial countries.[32] This may have acted as a brake on growth by limiting the contribution of the less affluent not only to consumption and national saving but also to productivity.[33] A good part of the population lacks the resources needed to invest in human capital, for themselves or their children, and to ascend the consumption ladder towards expenditure possibly having a greater cultural content. This part of the population, living largely in the South, risks being cut off from the possibility of making the best contribution of its human potential to the country's economic progress. The picture is aggravated by comparatively low social mobility, unchanged across generations and even diminished across jobs. Stagnation and the very rapid aging of the population certainly do not favour social dynamism.

A synthesis in historical perspective. – Given the size of the deterioration in the variables reviewed in the preceding section and the elasticity to growth of some of them, as a group they may have prevailed over the variables favouring development. Taken together, they appear sufficient to explain the growth décalage on the order of 1 percentage point suffered by the Italian economy in the last ten years.[34]

A very summary interpretation of the décalage can be put forward. On the one hand there has been an acceleration in the changes in techniques (ICT is only the best known example) and comparative advantages (the primacy of some industrial countries in terms of access to the new technologies and the appearance on the international scene of countries capable of quality and lower costs in manufacturing Italy's traditional products). On the other hand the Italian economy has been less than prompt in exploiting these opportunities, coping with the challenges inherent in them and reallocating resources owing to the *combination* of three factors: shortcomings within firms, handicaps imposed on firms from outside and, *lato sensu*, insufficient competitive stimuli for producers.[35]

These factors, described here sequentially for ease of exposition, almost certainly interact. The low level of competition does not induce firms to accumulate more capital and grow larger; external diseconomies discourage them from facing the costs and risks inherent in attempting to overcome the shortcomings within the productive system by these two means. The defence of profitability is entrusted to collusive and protectionist mechanisms, to preservation of the status quo. The slower growth of the economy perpetuates the burdens originating in the public finances. The internal shortcomings are accentuated. A vicious circle prevents the economy from responding to the increasingly severe external challenges, from fully exploiting the opportunities offered by technical progress and the shift in comparative advantages.

A purely economic explanation of such a complex social phenomenon as the growth, or non-growth, of a country's productive capacity over a decade may appear unsatisfactory, incomplete. In reality, empirical correlates and ultimate determinants of a meta-economic nature can be found for each of the explanatory variables referred to above. Fulfilment, individualism, familism, localism, aging, lack of education – rooted deep in the Italian social body, these factors are sometimes cited even by economists. Equally, the country's institutions are cited, in a broader but vaguer sense with respect to law and economics and company law.

In a historical perspective a recurring condition in Italy is the appearance of the problem of the economy as a problem of growth, with the country perpetually teetering between progress and backsliding. Carlo Cipolla has clarified the key point in a secular perspective: the wealth of Italians is never acquired permanently. The risk of a standstill, of hard-won positions being lost, is ever present. Italy is without "natural" endowments, above all sources of energy. Imports are necessary, exports vital. Italian manufacturers are at a disadvantage in terms of primary resources that they, no less than those who govern the country, must make good. Constant pressure must be maintained against monopolies, moral hazard, collusion and corner-cutting, but also against the provincial presumption of having caught up with more richly endowed nations, of having overcome the economic problem, of being "rich for ever". Such pressure is essential to prevent firms from straying from the strait and narrow: the endless search – based ultimately on study in "schools" and "workshops" – for innovation, quality, value added to imported inputs, export capability.[36]

In a non-competitive context high profits such as those of the 1990s may lead to stagnation rather than growth. They may be consumed merely in consolidating firms' financial situations. By contrast, profits earned in an increasingly competitive environment generate growth, as happened twice in Italy's economic history: during the period of Giolittian prosperity (1900-1913) and during the postwar "economic miracle" (1950-1963). In the first case the competitive stimuli deriving from the fixed exchange rate, the lowering of customs barriers and the neutrality of the State in the tug-of-war between profits and wages combined with the opportunities offered by international expansion, the worldwide fall in interest rates and emigrants' remittances. In the second case the competitive threat that well-managed public-sector enterprises posed for large private-sector firms and the reopening of the economy combined with the opportunities offered by the unlimited supply of labour, the easing of the energy constraint and investment in infrastructure. Between 1957 and 1963 Italian firms raised gross fixed investment to one third of GDP. Not a few "small" ones became "medium-sized". Together they produced a formidable, winning response to the challenges created by the Common Market, thus dispelling the fears that this nonetheless had engendered. They succeeded in grasping the opportunity provided by the creation of trade flows within Europe. The fact that the renewal of competitive stimuli was sacrificed to "planning" was the most important shortcoming of economic management in the 1960s and 1970s.

The way out of the bind. – Economic growth depends on the simultaneous action and interaction of four elements: the international context, the productive structure, the burdens weighing on the economy and the factors stimulating it. When, as the international context changes, the balance between propulsion and resistance breaks down, the burdens become excessive, the stimuli insufficient. The structural shortcomings are accentuated. Expectations worsen. The economy stagnates.

Today, this is once again the case of the Italian economy. There should be agreement on the nature of the problem, if not on all its causes; different views are likely on the specific measures to be taken and the desirable courses of conduct. Analysis does not produce the "recipe" and its ingredients. It can suggest guidelines for overcoming the stagnation afflicting the Italian economy: strengthening the productive structure, reducing the handicaps that weigh down Italy Inc. and creating competitive stimuli for producers in a climate of improved expectations. Ideally, policy and behaviour should act on these three fronts simultaneously, aiming to bring about a new, more advanced, balance between incentives and impediments. The synergism of opportunities, abilities and stimuli is as necessary as it is difficult to achieve along the knife-edge of growth.

Consolidation of the public finances by means of reforms,[37] modernization of the country's infrastructure and networks, partly in the context of major European projects,[38] reform of the legal framework for the economy,[39] promotion of competition in a dynamic sense,[40] and correction of territorial and distributive disparities are still the major challenges that face the political and administrative classes. But "the management of the country's affairs" (Raffaele Mattioli) is the responsibility, at the various levels, of the entire governing class.

The confidence of entrepreneurs in the future of their businesses must correspond to the risks to which the Italian economy is exposed: risks that are serious but not insuperable. If the problem of competitiveness involves not only the price but also the quality and composition of output, then it is necessary to invest more and differently, including investment in infrastructure and networks coordinated at the national and European levels. Thanks to the restoration of sound monetary conditions, interest rates are at a historical low, also by international standards. Firms' financial situations – profits, equity capital and leverage – have improved with respect to the not-so-distant past. The rate of increase in nominal wages is still moderate, in the wake of the success of the incomes policy introduced in 1993, in what was becoming in some respects a "cowed labour market".[41] Human capital, research, innovations in the relationship with the scientific community, increases in firm size, corporate governance, willingness to consider contributions of all kinds and not just of capital, acceptance of competition are some of the many ways in which entrepreneurship can be expressed in the four million productive units with which Italy is endowed.

Recognition of the seriousness of the situation requires workers and unions to move in a well-defined direction: to supplement possibly fiercer bargaining over real wages and the distribution of income with a new opening on the fronts of labour mobility and forms of employment. It is possible to imagine legal solutions that would better reconcile protection of both the employed and the unemployed with the need for dynamic reallocation of human resources and capital. The immobility of resources is incompatible with innovation in products and techniques. Of fundamental importance is the upstream defence of workers through quality public education that puts them on an equal footing at the start.[42]

A realistic and necessary objective. – If implemented systematically and synergically, interventions and courses of conduct such as those outlined in the preceding section would put the Italian economy back on a higher growth path. How much higher and over what time span it is impossible to say. The notion of potential output is of no help for an economy whose future depends crucially on *changes* in both economic policy and producers' ability to respond and, above all, on their mutual reinforcement. Some insights can come from comparative analysis, which has been eschewed so far in this paper, insofar as I have focused deliberately on the shifts over time in the main determinants of Italian economic growth.

Over the last decade the US economy grew at an annual rate of more than 3 per cent in terms of GDP, thanks in part to the expansion of the population. Other countries with a high level of income but a less pronounced increase in population saw GDP grow at annual rates of just under 3 per cent, the OECD as whole achieved 2.6 per cent. A rate of between 2.5 and 3 per cent should be well within the reach of an Italian economy in which the actions described above are taken – one point, at least, higher than the 1.6 per cent achieved in 1993-2002. Compared with the other European economies and the OECD, Italy has a similar national saving rate (20 per cent of GDP) and the figure for household saving is one of the highest (12 per cent of disposable income); setting aside demographic trends, the pool of potentially available labour is large, the stock of entrepreneurial skills abundant, and the best technology accessible. There are no grounds for believing that the Italian economy – once the unfavourable conditions propagated and prolonged by 11 September have been overcome, the weaknesses removed, albeit gradually and not without difficulty, and the strong points reinforced – will not grow at least as fast as comparable economies have succeeded in doing.[43]

The scale of the objective is made clearer by considering not only the conspicuous size of the increase in economic activity (about $20 billion per year at a realistic exchange rate) but also the fact that it would allow a doubling of GDP in 27 years instead of 44,[44] a less painful adjustment of the pension system and a conspicuous increase in consumption.

Italian society has many unsatisfied needs, individual and collective, present and future. It is aging. In such a society it is senseless even to suggest the irrelevance of growth in GDP, economic maturity and the possibility of renouncing the criterion of efficiency.

One last consideration. The concept of the stationary state is a fascinating one – by means of which Ricardo attempted to do without history – but it is potentially misleading. A zero-growth economy may contract; it may then fail to return to a stationary equilibrium. There are various reasons – the public debt, the pension system, the age structure of the population and demographic regression, the personal and regional disparities of income – to believe that, starting from zero growth, the involution scenario is more likely for Italy.

It is possible to overcome the problem of growth besetting the Italian economy, or at least to gain that precious extra point. It is not only possible, it is necessary.

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[1] *Regarding the mechanics of economic progress in Italy after the war see the reconstruction by Ciocca, Filosa and Rey in P. Ciocca, L'instabilità dell'economia, Chap. VI, Einaudi, Turin, 1987. A reinterpretation, not out of line with the present work,*

is G. Nardozzi, "The Italian Economic Miracle", in Rivista di Storia Economica, No. 2, 2003, pp. 139-180.

2 *This tendency, which is common to other industrial countries, has been particularly sharp in Italy, as well as in Japan, which has experienced a speculative bubble due to overinvestment, and in Germany, which has had the burden of unification. Since the 1980s Italy has achieved less economic advance than the world, OECD and European averages.*

3 *"The conventional wisdom – which I believe to be correct – takes the general upward trend to be driven mainly by factors on the supply side: by improvements in the education, training, and skills of workers; by technological innovation; and by increases in the stock of machinery and equipment per worker as well as the replacement of obsolete equipment with new versions adapted to the latest and most productive technology … That business investment can stimulate both short- and long-term growth is a reminder that demand-side and supply-side forces are not wholly independent of each other…". R.M. Solow, "Mysteries of Growth", in The New York Review of Books, 3 July 2003, p. 49.*

4 *In the last decade the average contribution of household consumption to demand has fallen to 0.9 percentage points of GDP, compared with 1.8 points in the previous decade. The contribution of public consumption has fallen from 0.5 to 0.1 percentage points, while that of net exports, which was slightly negative in 1983-1992, has been practically nil. In a long-term analysis we can gain a better understanding of the problem of demand from simulations for the past ten years. Had exports retained their market share, then, taking all the interactions into account, they would have guaranteed that aggregate demand expanded annually in real terms by half a percentage point more than was the actual case. An increase in labour productivity a quarter of a point greater than observed would, in turn, have been enough to ensure, in various ways, approximately 1 point greater growth in both total and domestic demand. Together, the two effects – 1.5 more points of GDP growth – would have kept aggregate demand growing at the rates recorded in the 1970s and 1980s (3 per cent per annum).*

5 *Exports decelerated in the later 1990s (the annual increase was 4 per cent between 1997 and 2001) and declined sharply in 2002 and 2003. They now account for 3.6 per cent of world exports of goods, compared with earlier peaks of 5 per cent in 1990 at current prices and 4.5 per cent in 1995 at constant prices. Other industrial countries have also lost shares to new exporters such as China. The drop in Italy's share has been the largest, however, and it has been large even compared with the exports of the industrial economies alone (down from 6.7 to 5.7 per cent between 1995 and 2002). The decline has been concentrated within the EU (1 point less in the past 7 years, 3 points in Germany). According to IMF estimates for 2002 based on purchasing power parities, the weight of the euro area in international trade (31 per cent) is equal to twice its share of world GDP (16 per cent) while Italy's is only one third greater (4 per cent compared with 3 per cent).*

6 *Italy has lost market shares despite the large depreciation (around 30 per cent) in the lira's nominal effective exchange rate between 1992 and 1995 and despite the fact that the subsequent appreciation was mild because the currency re-entered the EMS in November 1996 at a prudential rate of exchange and the euro depreciated between January 1999 and February 2002. Compared with the ten years up to 1992, Italian products have been only moderately successful on international markets in the past decade, even though on average they have been more price-competitive. A gradual decline in price competitiveness has reached a cumulative 28 per cent between the peak of April 1995 and June 2003 (15 per cent between the average for 1995 and the average for the first half of 2003). Italy continues to specialize in the production of goods requiring medium-to-low human capital, for which international demand (European in particular) is slack, that use imitable technology and are vulnerable to competition from recently industrialized countries. There are very few signs that Italy's model is converging on that prevailing in the euro area. In sectors with a high value added and dynamic demand (computers, chemicals, pharmaceuticals, consumer electronics) Italy is actually despecializing, virtually forgoing such areas of production as computers, biotechnology and fine chemicals. See M. Bugamelli, "Il modello di specializzazione internazionale dell'area dell'euro e dei principali paesi europei: omogeineità e convergenza", Temi di discussione, No. 402, Banca d'Italia, 2001.*

7 *Although direct investment abroad has increased, it is still only just over 1 per cent of GDP (compared with 5-6 per cent in France, Germany and Spain). Equally small (also around 1 per cent of Italy's GDP) is the flow of foreign capital into Italy – obviously because returns are perceived to be insufficient.*

8 *On average for the period 1993-2002 the overall rate of investment was lower than in 1982-1991 (19.3 per cent compared with 20 per cent) while the rate of "non-residential" investment was marginally higher (14.6 against 14.4 per cent). In the same period the average contribution of gross fixed investment to the growth of aggregate demand (0.3 per cent) was slightly less than in the previous decade (0.5 per cent). The ratio of total spending on R&D to GDP did not change over the two decades (1.1 per cent), neither did that of the private component (0.6 per cent). Non-residential capital per worker continued to increase at around 2 per cent per annum, however, which was no slower than in the decade up to 1992. After the drop in 1993-1994 following the exchange crisis in the summer of 1992, the ratio of investment to GDP at constant prices continued to rise uninterruptedly from 17.8 per cent in 1994 to 20.8 per cent in 2001-2002. The expansion in the "non-residential" component was even faster, up from 12.7 to 16.2 per cent of GDP.*

9 *In the course of the decade the share of value added going to profits increased by five percentage points to a historic peak, registering an average four points above that for the decade to 1992. At 7 per cent the return on equity for a broad sample of mainly industrial firms (ROE after taxes and net of financial costs) was more than one point better than in the decade preceding the recession. Net financial costs for "non-financial" firms declined from 9 per cent of value added in the years immediately preceding 1992 to between 4 and 5 per cent in 1998-2002. Firms elected to reduce their debt burden (for the "non-financial" firms their leverage – debt over debt plus equity – was reduced from 55 per cent in 1990-91 to 39 per cent in 1998-2002) and to consolidate ownership control (in manufacturing firms with more than 50 employees, on average 65 per cent of share capital is held by the top shareholder).*

Positive though they are in terms of financial stability, these developments did not result in stepped-up capital formation or swifter entrepreneurial turnover. They did not stimulate the growth of output, either actual or potential.

[10] *An equation for investment in plant, equipment and transport equipment hinging on aggregate demand and the relative prices of productive factors in the last decade provides a highly accurate interpolation of the data. There are no signs of instability in the parameters. The sum of the residuals is close to zero. Systematic errors for the decade do not emerge even if the equation is estimated on a sample of observations from before 1993.*

[11] *Trade openness (defined as half the ratio of exports plus imports to GDP at current prices) had declined to 15 per cent in 1992. Since then it has risen, and in the last three years has stood at 20 per cent. Financial openness (defined as half the ratio to GDP of capital inflows plus outflows for direct and portfolio investment) rose from 2 per cent at the end of the 1980s to 10 per cent in 1999. The value of non-banks' capital transactions in the balance of payments increased 15-fold as regards Italian capital, 26-fold as regards foreign capital.*

[12] *Within the financial sector the banking industry increased the volume and the range of intermediation and of its services. It increased productivity and cut unit labour costs. It strengthened its capital base. It refined the management of credit and risks. It eliminated inefficient banks, without trauma. It carried out mergers and acquisitions, corporate restructurings. It saw the rise of large groups, three of them now among the largest in Europe. At the same time, institutional investors came into being, the money and financial markets grew greatly in size and made enormous progress in organizational and informational efficiency. Among banks and non-bank intermediaries competition increased considerably. The increase involved both product markets and the market in ownership and control of financial enterprises. The disparities in interest rates, including geographical disparities, were significantly narrowed. P. Ciocca, La nuova finanza in Italia. Una difficile metamorfosi (1980-2000), Bollati Boringhieri, Turin, 2000.*

[13] *The rate of inflation since 1993 has averaged 3.1 per cent, compared with 7.5 per cent from 1982 to 1992. Italy's international investment position swung from a net debtor position equal to 11 per cent of GDP in 1992 to a net creditor position. Now there is again a net debt, owing in part to the current account deficits run since 1999. Interest rates are at historic lows, in line with the rest of Europe. Since the incomes policy pact of 1993, wage moderation has been assured. The non-accelerating-inflation rate of unemployment has been declining since 1995-1996.*

[14] *The deficit was cut from 11 per cent of GDP in 1992 to below the EU's 3 per cent threshold in the years following 1997. From 1992 through 2000 the "negative" impact of restrictive fiscal policy averaged less than 0.4 percentage points a year, with a maximum of 1.4 points in 1995 (see S. Momigliano and S. Siviero, "Appraising the Effects of the Budget on the Economy with an Econometric Model: The Italian Fiscal Adjustment in the Nineties", Rome, typescript, March 2002). Even adding in these "lost" decimal points, the economy's growth performance during these years remains mediocre. A credible anti-inflationary monetary policy stance of high short-term interest rates, acting in advance and working on expectations, helped to bring down long-term rates, which are crucial to investment. Had the deficit not been reined in, and had inflation not been overcome, then the recession would have been dramatic indeed.*

[15] *Higher unemployment and lower employment; low labour force participation; stagnation and rapid aging of the native population; barriers to immigration, to the social integration of immigrants and their better utilization – these patterns correspond to the slowdown in the contribution of labour inputs to growth in per capita GDP (as shown by growth accounting). In what is perhaps an overestimate, "grey" labour has been said to account for 26-27 per cent of Italian GDP, compared with 16-17 per cent for the OECD economies as a whole (F. Schneider and D.H. Enste, "Shadow Economics: Size, Causes, and Consequences", Journal of Economic Literature, 2000, p. 104). These same negative features may, to some degree, be reversible. And if a start is made on righting them, they may actually represent an opportunity for growth. The Italian economy does not lack labour resources.*

[16] *C. Dell'Aringa, "The Italian Labour Market: Problems and Prospects", Università Cattolica, Milan, February 2003, p. 4.*

[17] *Formal centralization and tacit cooperation were strengthened after 1993, in part through the incomes policy agreement. Labour conflict diminished considerably. Since 1997 the tax and social security contribution wedge has narrowed. Unemployment benefits remain low. Active labour market policy remains insufficient, but the public employment service has now been reformed and decentralized. Employment protection legislation remains rigid – especially for larger firms – as regards individual and collective hiring and dismissal of regular, permanent employees, but it has become much more elastic as regards fixed-term contracts and temporary employment agencies and also in terms of working hours.*

[18] *The average annual increase in real earnings per standard labour unit in the private sector fell from 1.7 per cent in 1983-1992 to 0.4 per cent in 1993-2002. Labour productivity in the two periods grew by respectively 2.3 and 1.8 per cent per year (measured by value added at factor costs net of rentals per standard labour unit).*

[19] *In large industrial firms turnover has been increasing. The number of employees involved has risen from 22 to 33 per cent of the workforce in the previous year, about the same as in other countries.*

[20] *From 1993 to 2002, the public debt averaged 117 per cent of GDP, compared with 90 per cent in the previous ten years. Its residual maturity is now 6 years (it was just 3 in 1992). The debt is still nearly 110 per cent of GDP, despite privatizations (with proceeds equal to 9 per cent of GDP against a value of the firms privatized equal to 20 per cent, including the discounted sale of the "family jewels" and the dismemberment of the large public groups), securitizations, and a securities swap with the Bank of Italy. Relative to GDP Italy's public debt is the largest in the OECD except for Japan (where it is 156 per cent). It is far above the European average of 62 per cent.*

[21] *Current revenue of general government rose steadily, from 34 per cent of GDP in 1980 to 42 per cent in 1990 and 47 per cent in 1997.*

[22] *About one third of the cost of labour consists of social security contributions to a pension system in which the ratio of retired to active workers is rising dangerously (from the present 27 per cent it is projected to go to 60 per cent in 2040).*

[23] *Between 1991 and 2001 gross annual expenditure on infrastructure amounted to 1.5 per cent of GDP, having fallen sharply in the last thirty years to the lowest level since Italian unification (wartime excepted). Net of depreciation, total investment was virtually nil.*

[24] *P. Ciocca, "Un diritto per l'economia?", Rivista Trimestrale di Diritto e Procedura Civile, No. 3, 2002, pp. 887-896; G. Carriero, P. Ciocca and M. Marcucci, "Diritto e risultanze dell'economia nell'Italia unita", in P. Ciocca and G. Toniolo (eds.), Storia economica d'Italia, Vol. 3, part II, Laterza, Bari, 2003.*

[25] *The relative importance of micro firms has also grown in other countries (the United Kingdom, France and the United States) where the economy is increasingly oriented to services, consumption is being personalized and legislation favours smallness. However, the phenomenon is far more pronounced in Italy, where it is widespread in nearly every branch of the economy and not only in traditional products. Comparatively, this is due not to different birth and mortality rates of small enterprises, but to the slowness of their growth after their birth. In the 1981 and 1991 censuses the average number of workers in Italian firms was 4.5. It fell to 3.9 in 2001 (data based on local production units). Firms with more than 500 workers — classified as "large" — numbered 1,265 in 1981 (with 2.4 million workers, or 18.8 per cent of the total), 1,173 in 1991 (with 2.6 million workers, or 18.1 per cent), and 1,061 in 1996 (with 2.2 million workers, or 16.2 per cent). Around 95 per cent of Italian firms have fewer than 10 employees; even in industry the average is only 6.5. Industrial districts and groups only partially compensate for the serious limit in the scaling up Italian firms. According to some calculations, the "districts" account for 40 per cent of the workers in manufacturing and 10 per cent of total employment in the economy. According to other calculations, which only include companies specialized in districts' typical products, the percentages are 13 and 3 per cent, respectively. Even though "groups" are widespread, they involve a very small percentage of firms, especially large ones. Among manufacturing firms with more than 50 employees, those belonging to groups fell from 47 to 40 per cent of the total between 1996 and 2001. See S. Trento, "Il ristagno dell'economia italiana: specializzazione o nanismo generalizzato?", typescript, Rome, 2003.*

[26] *See S. Rossi (ed.), La Nuova Economia. I fatti dietro il mito, Il Mulino, Bologna, 2003. Relatively limited use is made of ICT by Italian companies, especially small firms.*

[27] *Of Italy's 900,000 industrial firms, those that export number 98,000, with 3 million employees (an average of 30 per firm). In the economy as a whole, which counts a total of 175,000 exporting firms, the incidence of exporting firms decreases considerably with firm size; only 3 per cent of companies with fewer than 20 employees export, compared with 62 per cent of those with 250 or more employees. In the manufacturing sector 1 per cent of export-oriented companies (the largest ones) account for 40 per cent of the sector's total exports, while 60 per cent of exporting firms, those with fewer than 10 workers, account for only 5 per cent. Exports to non-EU markets are virtually the exclusive preserve of large companies, which are also the only ones able to export simultaneously to more than one country. The cyclical elasticity of exports also decreases sharply with firm size.*

[28] *See the systematic study coordinated by Ignazio Visco at the OECD, The Sources of Economic Growth in OECD Countries, Paris, 2003.*

[29] *W.J. Baumol, The Free-Market Innovation Machine. Analyzing the Growth Miracle of Capitalism, Princeton University Press, Princeton, 2002.*

[30] *See N. Cetorelli and R. Violi, Forme di mercato e grado di concorrenza nell'industria bancaria dell'area dell'euro, Ente Einaudi, Quaderni di Ricerca No. 35, Rome, 2003, pp. 37-38 and 43-44. One might think that fragmentation into myriad firms favours competition. In reality, the contrary may be true. Small firms, especially if little inclined to grow, constitute a less worrisome threat to the other companies in the same market. They have little capacity to innovate. Their high costs limit their potential to reduce their selling prices. For a number of reasons, collusion, herd behaviour and tacit agreements are possible in sectors where production is divided among a large number of mini-companies. These are the very sectors of the Italian economy with the highest margins and the least competition by international standards. See OECD, Economic Surveys. Italy, Paris, July 2003, p. 49.*

[31] *F. Onida, "Crescita, competitività e dimensioni d'impresa nella proiezione internazionale del sistema produttivo dell'Italia", Economia italiana, 2002, p. 699.*

[32] *The indices of concentration of personal income in Italy (the Gini index is around 34 per cent) are high compared with other advanced economies and the EU, though lower than those of the United States. The indices of concentration of wealth stand at around 60 per cent. Both measures of concentration have increased. From 1993 to 2002 not only did the economic gap between the South and the rest of the country not narrow but it actually widened further: average per capita income in the South is 57 per cent of that of the rest of the country, compared with 60 per cent in 1983-1992. Areas of underdevelopment persist in the South. Inequality in the distribution of income is high (the index of concentration is 36 per cent, compared with 29 per cent in the Centre and North); inequality of wealth is particularly high in Campania and Sicily.*

[33] *The connection between growth and distribution requires analytical caution at both the theoretical and the empirical level: "As for inequality, I suspect its causal connection to the trend in growth is weak. … Besides, there is nothing in this kind of correlation to tell you what is causing what: Do fast-growing countries reduce income inequality or does lower income inequality favor growth?", Solow, op. cit., p. 51.*

[34] *Econometric analyses of the growth record based on cross-section data have estimated that, ceteris paribus, a reduction of 1 percentage point in the tax burden raises per capita GDP by 0.6 to 0.7 per cent; an increase of 10 per cent in investment in research and development raises per capita GDP by 1.2 per cent and its trend growth rate by 0.2 points; a 1 point increase in the ratio of investment to GDP raises output per worker by 1.3 per cent. The increased R&D investment would be obtained, among the various possible ways, if the average size of Italian firms were reasonably larger. The intensification of competition produced by a (gradual, decade-long) easing of regulatory restrictions and lowering of entry barriers to bring them into line with the average levels in the OECD area would raise total factor productivity growth by several tenths of a point. (See, among others, R.J. Barro, "Human Capital and Growth in Cross-Country Regressions", Swedish Economic Policy Review, 1999; OECD, op. cit.; G. Nicoletti and S. Scarpetta, Regulation, Productivity and Growth: OECD Evidence, OECD Economic Department Working Papers No. 347, January 2003, especially p. 40.) No less considerable are the effects of different legal and institutional structures on growth (see R. Hall and C. Jones, "Why Do Some Countries Produce So Much More Output Per Worker Than Others?", Quarterly Journal of Economics, 1999). The ability of the factors discussed in the preceding section to explain the slowing of economic growth in Italy would be even more evident if account were taken of non-linearity and interactions that econometric analysis has more difficulty in capturing.*

[35] *"Like a farmer using a carrot and a stick to coax a donkey forward, the market system …", P.A. Samuelson-W.D. Nordhaus, Economics, McGraw-Hill, Maidenhead, 1995, p. 25.*

[36] *C.M. Cipolla (ed.) Storia facile dell'economia italiana dal medioevo a oggi, Mondadori, Milan, 1995. For Cipolla the roots of the North-South gap lie in the secular interweaving of economic structures and cultural stratifications. See C.M. Cipolla, "Il caso Mezzogiorno? Colpa dei normanni", Il Sole 24 Ore, 1 May 1996.*

[37] *The economic cycle apart and considering realistic interest and growth rates, the primary budget surplus needed to reduce the ratio of the stock of public debt to GDP by 3 percentage points per year is around 5-6 per cent of GDP (it was 3.6 per cent in 2001-02). For a given primary surplus, increasing public investment in infrastructure and human capital and reducing the tax burden on the economy requires a corresponding reduction in primary current expenditure. Purchases of goods and services, wages and salaries, pensions are, in order of the time needed to produce effects, the candidates for such far from easy expenditure savings.*

[38] *Concentrating at one extreme on truly useful large-scale transport projects but at the other also on higher education, scientific research, high-tech sectors, and the preservation and restoration of the country's unique artistic and natural heritage.*

[39] *There is an urgent need for legal reforms that, consistently with the company law due to come into force at the beginning of 2004, will provide scope for entrepreneurship, simplify formal acts, broaden the range of possible organizational solutions for firms, encourage the increase in firms' size (with the support of a tax system that takes this crucial aspect into account). A new legal system must be created for the economy (from bankruptcy procedures, to labour law, civil procedure and antitrust law) with a view to promoting a "market economy with rules". In conformity with Community law, this legal system must be suitably framed, capable of meeting the specific needs of the Italian economy. Empirical comparative analyses carried out in the last few years have confirmed that the legal and institutional spheres exert a considerable influence – through the accumulation of capital, better use of resources, certainty of contracts and transfer of risks – on the growth of the economy.*

[40] *Competition must be "imposed", by laws and on laws, by means of dynamic antitrust activity, in addition to the static protection of consumers, based on priorities dictated by what the economy needs in order to grow, and through behaviour on the part of the public sector that counters moral hazard, collusive practices and rents and leads producers to assume responsibility for their actions and, above all, to be self-reliant. "One shortcoming of the liberal economic order … is that individuals seek, on occasion, to pursue their own (economic) interests by political means. They seek regulation, political influence, and protected monopoly. They have money and use it to buy power." E. Rothschild, Economic Sentiments: Adam Smith, Condorcet, and the Enlightenment, Harvard University Press, Cambridge (MA), p. 157.*

[41] *P.A. Samuelson, "Wherein Do the European and American Models Differ", Temi di Discussione del Servizio Studi, Banca d'Italia, 1997.*

[42] *The allocation of resources over time and knowledge are the key factors in the analysis by L. Pasinetti,* Dinamica strutturale e *sviluppo* economico. Un'indagine teorica sui mutamenti nella ricchezza delle Nazioni, Utet, Turin, 1984.

[43] *This is confirmed by the econometrically estimated parameters summarized in footnote 34. Given these parameters, the values the independent variables should take on for growth to revive significantly are not beyond the reach of the Italian economy.*

[44] *It is well known that Keynes was fascinated by the "magical consequences", the "incredible effect" "of compound interest": "If the proceeds of one Spanish galleon seized by Drake had been invested abroad at 5 per cent compound interest, the value at the present day would be many times that of the whole of our actual foreign investments".* The Collected Writings of John Maynard Keynes *(D. Moggridge, ed.), vol. XII,* Economic Articles and Correspondence. Investment and Editorial *(letter to F.P. Ramsey, summer 1928), Macmillan, London, 1983, p. 785.*