BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1990

THE GOVERNOR'S CONCLUDING REMARKS

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As I open this Meeting, my thoughts and those of all who work in the Bank turn with emotion and respect to the memory of Paolo Baffi, who died on 4 August 1989. I shall pay tribute to him in the words in which I commemorated him at the meeting of the Board of Directors in September.

The death of Paolo Baffi has deprived our Bank and all its staff of a landmark. His passing leaves me with a feeling of loss, a feeling that I am sure you share. His legacy of words and deeds is one of unstinting devotion to the generai interest.

His very presence discouraged superficiality; he raised the moral and professional standards men used in their judgements; he helped to give a firm meaning to the mandate and actions of those entrusted with public responsibilities.

Paolo Baffi's professional life was wholly dedicated to the nation. It formed a strand of the history of the Bank of Italy, to which he contributed a stream of ideas and deeds of inestimable value over a span of more than fifty years. From the moment he joined the Bank in 1936 his participation was decisive in establishing a method of work in which rigorous analysis and independent judgement are seen above all as a duty, one of the ways in which the Bank fulfils its function of serving the public.

Over the years generations of officers of the Bank of Italy were at once intimidated and stimulated by Paolo Baffi's extraordinary combination of penetrating logic, erudition and moral strength. He did more than any other person to mould the Bank's staff, both directly and indirectly through his prestige and example. Outside the Bank too, he would surprise his interlocutore with his readiness to hear new arguments, to subject them to meticulous criticai appraisal and to offer other ideas and facts in response.

But Baffi was not only a gifted student of economics, he had a deepseated commitment to act for the common good; his long service as Economic Adviser, then as Director General and finally as Governor attests to it.

In the post-war years he helped to formulate the technical aspects of the "Einaudi" line of monetary stabilization and defended it effectively in the ensuing debate. He was the intellectual inspiration of the Research Department, but also its organizer and guiding spirit.

From 1960 to 1975, when the growing difficulties of the economy required monetary policy to undertake new tasks, he worked to equip the Bank with the necessary instruments and internai structure and to enhance the professional standards of its staff.

In 1975, at the beginning of what he was later to recali as "my five years in the front line", the recessionary impact of the rise in oil prices caused national income to decline for the first time since the end of the war. There was concern Test monetary restriction should play havoc with the economy, a prospect Baffi dreaded. Once the worst of the crisis in 1976 had been overcome by means of a package of economic, monetary and foreign exchange measures, Baffi helped to guide the economy towards balance-of-payments adjustment and renewed creditworthiness.

In international fora his personal prestige helped restore a climate of confidence and reinforced the international community's willingness to support Italy in its efforts to achieve more orderly economic and financial conditions.

Disinflation and external adjustment enabled Italy to keep tts appointment with the European Monetary System in 1978-79. Baffi prepared for it with a clear awareness of the limits of the Italian economy's ability to withstand competition, and with skillful diplomacy he pursuaded the other countries to accept the implications of those limits for the lira. Economie progress was achieved while stagnation was avoided and, with the cyclical upswing of profits and investment in 1978-80, firms began to recover their financial and operational equilibrium, which had been seriously perturbated in earlier years.

In Baffi's view monetary stability was more than just a necessary condition for economic efficiency. Above all, as his writings show, he felt duty-bound to help safeguard the nation's savings from the "unjust tax" of inflation and, in particular, to shield the most vulnerable sections of society: the young and the old, who would allo have been the hardest hit by an excessively rigid monetary policy, especially in a situation of widespread indexation of nominai incomes.

Paolo Baffi resigned as Governor in October 1979, as he feared that the Bank might suffer as a consequence of the legai charges that had been so unjustly brought against members of the Directorate. The anguish was inexpressible for him, but it was shared and translated finto a renewed commitment by the entire Bank. Paolo Baffi's stature is all the greater for the example of dignity that he offered. We would, however, be doing a disservice to his outstanding qualities, to the breadth and diversity of his achievements, if we concentrated on that painful affair in our remembrance of him.

Deeply wounded but not broken, he continued — in the reserved style of a Menichella — to render active service to the country and to the international community: to the Bank as Honorary Governor; in the Academy of the Lincei, the Italian Society of Economists and the Bank for International Settlements; as a member of committees concerned with the environment, health, the debt of the poorest developing countries and the relationship between law and economics. Generous in his relations with young people, he lent his support to the organization of economie study and research to the very end, not least as President of the Einaudi Foundation.

His professional rigour and civic commitment have left their mark upon us all. With gratitude and pride, the Bank will cherish and draw profitably on his teachings and personal example.

The Bank of Italy is carrying out a number of projects as a permanent tribute to the memory of Paolo Baffi. The new reading room in the Research Department's library will be dedicated to him; the Bank is arranging the publication of his complete academic works and a volume of recollections; and every two years an eminent economist will deliver the "Paolo Baffi Lecture on Money and Finance".

In a year that saw significant changes and innovations in the Bank 's operating techniques, the staff continued to perform its duties with professionalism and commitment. I wish to express my sincere gratitude to them.

The world economy

The Community and Central and Eastern Europe

For nearly half a century the world economy has operated in a context that has been made rigid by the rivalry between the two protagonista of the post-war era. Within a short space of time, however, the rapid course of events in Central and Eastern Europe has opened up new vistas. In analyzing the economie developments of the past twelve months, one seeks to discern how the future will unfold in the new international political configuration that is now taking shape, and which has been and will continue to be influenced by economie events.

The changes now occurring are creating an opening for a more significant European presence, for a Europe rich in civilization and awakened to its capacities and responsibilities by long meditation on the events that devastated the continent in the first half of our century.

By virtue of the strength it has acquired through the development of individuai economies and economic and political integration centred on the

EEC, Western Europe can now become a point of reference in the world order. Far from making the Community project irrelevant, the sudden widening of the international horizon makes its completion all the more urgent.

The completed Community should be perceived not as a closed entity, but as a motor of more extensive European cohesion, a benchmark for adjoining areas, an active ingredient in the solution of international problems. The network of relations between the Community and its dose neighbours can assume a variety of institutional forms appropriate to different needs and situations.

The further impetus to integration deriving from the Single European Act in the statile conditions guaranteed by the European Monetary System has dispelled the risk of sclerosis that threatened Europe only a few years ago. The member countries of the Community have reaped substantial benefits from free trade; with the elimination of borders now in prospect, the spur to greater efficiency is acting upon national economies as a whole, and not only on individuai firms.

The reality of the Community economy permits new relations with the countries of Central and Eastern Europe to be built on sound foundations. These countries are engaged in a radical transformation, which will succeed only if juridical, institutional and social reforms are introduced, as well as economic ones. They require massive resources; this implies not merely granting aid, but initiating collaboration between two areas that were artificially separated for decades. The injection of financial and technical resources will enable those countries to achieve substantial productivity gains, if it is accompanied by radicai changes in economic organization. Once most of the pent-up consumer demand has been met, growth will be accompanied by savings formation on a scale that should gradually make investment and the development of these economies self-sustaining. A process should develop that would bring prosperity to all of Europe by raising the potential for growth.

To be successful, the process will have to surmount dangers and difficulties; opportunities and risks are closely interwoven.

In the Community countries themselves, with their present high rate of capacity utilization, additional foreign demand could generate inflationary pressure in the short-to-medium term. This would only increase if room to accommodate the greater allocation of resources for external uses were not made by encouraging higher domestic saving, first and forem ost through budgetary policies.

The countries of Central and Eastern Europe face a daunting task. Their economic structure is weak, marked as it is by serious distortions, obsolete plant, low productivity, poor product quality and manifest or latent inflation. Several of them are heavily burdened with foreign debt. Their rates of economic growth have been slowing down in recent years and for the most part turned negative in 1989. Partial reform of the planned economy is obviously not enough. The fundamental solution is to create a market economy, in which prices and rates of return will foster better resource allocation and the restoration of monetary equilibrium. Conditionality and project appraisal must govern the support provided by international organizations, beginning with the new European Bank for Reconstruction and Development, in order to promote the necessary innovations and prevent the dissipation of resources. This will entourage a flow of direct investment, bringing entrepreneurial abilities as well as capital.

On account of its size and diversity, its history and the very fact of being a great power, the Soviet Union faces an extremely complex task of economic transformation. The reform process that began five years ago has encountered obstacles in the coordination of its various components; the expected benefits have been slow to appear.

German unification is the issue that stands out in the context of relations between the two parts of Europe. Despite the Federal Republic being far larger than the German Democratic Republic, monetary union, the first important manifestation of unification, is not without problems. The basic decision that has already been taken, namely to entrust responsibility for monetary management to a single institution, the Bundesbank, from July onwards, will make them easier to resolve. The Bundesbank's commitment to the stability of the Deutschemark will find support in the growing cooperation among the centrai banks of the EEC. The increasingly dose ties among member countries, reaffirmed most recently at the European Council in Dublin, are a guarantee that the cohesion achieved within the Community will be preserved and strengthened, even with the new configuration of Germany.

Our meeting last year was held soon after the presentation of the Report of the Delors Committee, which drew up the pian for economic and monetary union. At its meetings in Madrid and Strasbourg, the European Council decided that the first stage of EMU would begin this July and called the intergovernmental conferente to be held before the end of the year to draft the amendments to the EEC Treaty. In Dublin in Aprii the Council set the end of 1992 as the date by which national parliaments must ratify the Treaty amendments, and resolved to begin preparatory work on institutional reform with a view to political union.

In June 1989 Spain joined the EMS exchange rate mechanism, opting for the wider fluctuation band. At the beginning of this year Italy adopted the narrow margins of fluctuation. France and Italy completed the liberalization of capital movements. Towards the end of 1989 the Council of Ministers of the EEC approved two Decisions, making it possible to intensify monetary policy coordination within the Committee of Central Bank Governors and to strengthen the monitoring of economie policies by finance ministers in order to achieve greater economie convergence. The preparations for the intergovernmental conference are proceeding.

Once the new Treaty has come into force the second stage of economie and monetary union can begin, during which the foundations will be laid for a single monetary policy and irrevocably fixed exchange rates, the prelude to a single currency. In this intermediate stage it will already be possible to establish the European System of Central Banks, with an initial transfer of functions from national central banks.

A balanced solution to the problem of budgetary discipline must be found and written into the Treaty. There is agreement that firm provisions are needed to prevent the automatic monetary financing of public deficits and prohibit the use of Community resources to bail out a member state that has not managed its finances with sufficient prudence. Discussion is still in progress on whether to introduce Community constraints on the autonomy of national authorities in order to reduce the risk of budgetary management that is prejudicial to monetary stability.

Recent developments and the outlook for the world economy

The extraordinary events we have been living through since the autumn found the industrial countries maintaining the strong momentum of the cyclical expansion that began in 1983. Last year their economies expanded by 3.5 per cent, a substantial increase, though smaller than that recorded in 1988. Fixed capital formation was again the fastest growing component of demand. A deceleration in GDP growth to between 2.5 and 3 per cent is forecast for this year, with the United States and the United Kingdom being particularly affected. World trade continued to expand at the rapid rate seen in the last few years, when it grew almost twice as fast as output. Employment increased by 1.8 per cent and unemployment diminished further.

Inflationary pressures, which had intensified in the closing part of 1988, were countered with restrictive monetary policies. Short-term interest rates rose over the year, by about 2 points in Europe and Japan, and inflation slowed down. Prices nonetheless rose on average by 4.4 per cent, more than one percentage point faster than in 1988. The persistence of inflation and the rates at which wages are increasing in some countries with tight labour markets are worrying.

The current account imbalances of the United States and Japan diminished; this was not the case of the German surplus or the deficits of some other EEC countries, Italy included. The depth and integration of the financial markets made it possible to cope with the disequilibria. However, the very-short-term and longer-term fluctuations in exchange rates avere large, especially for the dollar, and this had repercussions on securities markets.

Closer international cooperation based on the consultations among the Group of Seven countries, the continued high level of investment and growing flexibility of new plant, coupled with more efficient inventory management, have fostered stability and confidence, which have helped to attenuate cyclical swings. These stili occur, but the eighties show that economie policies geared towards long-term stability can prolong the expansionary phase of the cycle.

Nonetheless, there are obstacles on the path of balanced growth that make progress uncertain.

I warned last year that a shortage of savings loomed for the world economy as a whole. Heavy demands will be made by large backward and overpopulated areas that are unable to generate the resources for autonomous development, by the need to invest in infrastructure and environmental protection and conservation, by the growing burdens aging populations will put on industrial countries' pension and health systems. Most of the higher saving required to meet these long-term needs will have to be generated by the advanced countries, in both the public sector and the private sector.

Where the policy mix is inappropriate, monetary policy is overloaded with tasks and faced with conflicting objectives; expectations worsen, instability is heightened and may spread via the financial markets to the real economy.

In the United States the scope for pursuing a restrictive monetary policy, as the control of inflation requires, is limited by the desire not to interrupt the growth of the economy and to keep the dollar at a level compatible with reduction of the current account deficit. In Japan monetary policy has to reconcile the need to counter the yen's weakness, which fuels inflationary pressures and is inconsistent with the current account surplus, with the desire to avoid stock market turbulence. In West Germany the prospect of unification has triggered a sharp rise in long-term interest rates, reflecting the fear that monetary rather than fiscal policy will have to bear the brunt of the problems arising from unification.

The economie variable that most clearly reflects the persistence of domestic and international imbalances and the deep-seated nature of the prevailing uncertainty is the interest rate. In the past decade it was historically high in real terms, even when the increased return on productive capitai is discounted; the differential compared with world economie growth has recently widened further. The key to lower interest rates, which would help to sustain development, lies in the rebuilding of durable equilibria; this must be the aim of all aspects of economic policy, and not just of monetary policy.

Freedom of trade is not yet complete and should be strengthened institutionally, widened geographically and extended to sectors which stili enjoy protection. This is the purpose of the current trade negotiations, known as the Uruguay Round, that the GATT member countries began four years ago. It is essential that the negotiations should achieve their objective of a significant, albeit graduai, liberalization in agricultural products, textiles and services. For the latter a code is being drawn up based on the principles of non-discrimination and transparency.

The developing countries are advancing with difficulty: their growth slowed down last year by more than one percentage point. The most heavily indebted are hard pressed by high international interest rates; every rise rapidly nullifies the often painful efforts made in the field of domestic economie policy.

In much of Latin America stagnation was coupled with severe financial instability. In the poorest countries, particularly in Africa, the results fall short of what is needed to raise per capita income. Developments in Asia were more promising: growth slowed down in India and China, but the growing number of newly industrializing countries continued to expand at a rapid pace, with inflation satisfactorily under control and increases in domestic demand beginning to be as important for growth as the expansion of exports.

With the cooperation of the international financial institutions, the debt strategy proposed by the US Treasury Secretary, Nicholas Brady, has been applied, with encouraging prospects, to a limited number of countries in Latin America and Asia, and negotiations are under way with others. However, wider application of the strategy is encountering difficulties: adjustment is discontinuous in some of the most heavily indebted countries and new lending by banks is insufficient. The need for a broader spectrum of measures is recognized. The international organizations are directing their efforts to this end; their analytical and problem-solving skills, together with their lending activity, have the potential to stimulate the flow of new public and private financial resources. The revival of bank lending can be encouraged by appropriate tax and regulatory changes.

The forms of relief for the lowest-income countries must be strengthened. The problem of the middle-income countries that are not covered by the Brady Plan and whose debt is held mainly by official creditore remains to be addressed. In any case it is crucial that debtor countries pursue effective macroeconomic and structural programmes, guided in this through the application of rigorous criteria by the international institutions. Only in this way will it be possible to restore conditions conducive to the repatriation of capital and foreign direct investment.

After protracted and difficult negotiations, the Interim Committee of the International Monetary Fund reached agreement this month to increase Fund quotas by 50 per cent. This injection of resources broadens the scope for the Fund's action in support of member countries' adjustment programmes. The tasks the Fund will be called upon to perform in the international debt strategy and the transformation of Central and Eastern Europe would have justified a larger increase.

The Italian economy

The main results for 1989

The adoption of the narrow EMS margins of fluctuation for the lira set the seal on the policy that had been pursued throughout the eighties. In accordance with our perception of the Exchange Rate Mechanism not simply as a technical instrument but above all as a commitment to bring about the convergence of the participating economies, we have been guided in monetary management and the conduct of interest rate and exchange rate policy by an anti-inflationary approach aimed at encouraging firms to become more competitive and to strengthen their productive base. The response of the Italian economy to the stimuli of economic policy and to market forces over the past decade is expressed in the narrowing of the inflation differential between Italy and the group of European countries with more statile currencies from a maximum of eleven percentage points to less than three; in the growth of 28 per cent in real gross domestic product, the largest expansion recorded by any of the leading EEC economies; and in the increase in employment by 800,000 persons. The unemployment rate has nevertheless risen from 8 to 12 per cent; the worsening of unemployment, which has occurred mainly in the South, reflects the substantial growth in the labour force, and especially the rise in the number of working women. The current account of the balance of payments has shown a persistent if moderate deficit.

Last year the exchange rate was again the point of confluence between anti-inflationary policy and the grand design for European monetary integration. The appreciation of the lira until the end of the summer countered the resurgence of inflation. The subsequent return of the lira's effective exchange rate against ERM currencies to the level recorded at the beginning of the year was the technical precondition for narrowing the lira's band of fluctuation in the EMS without altering its lower intervention margin, in other words, for ensuring that such action was credible and at the same time reaffirmed the determination to pursue monetary stability. The success of the measure has been demonstrated by the renewed strength of the lira in the months that have followed.

The risk of economic overheating was averted, not only by means of monetary and exchange rate policy but also by timely': albeit partial corrections of budget trends. The measures taken in March 1989 held the state sector borrowing requirement for 1989 down to 132,3 trillion lire, a figure broadly in line with the Government projection made at the time but 15 trillion lire above the ceiling laid down in the Finance Law. Net of interest payments, the deficit was reduced from 3.4 per cent of gross domestic product in 1988 to 2.3 per cent.

There was a dangerous acceleration in inflation in early 1989. In the three months from February to April the increase in the cost of living, net of indirect taxation, jumped to an annual average rate of over 9 per cent. This acceleration came on top of the rising trend that had been evident since the summer of 1988, fueled externally by the appreciation of the dollar and higher prices for raw materials, especially oil products, and internally by rising labour costs. Strong demand enabled firms to pass the higher costs on to prices.

By containing the rise in import prices, relieving the pressure of domestic demand and moderating expectations, economic policy ensured that the higher rate of inflation did not become established but was just a flare-up. In the period from May to December the rise in the cost of living, net of indirect taxation, fell back to an annual average rate of about 5 per cent. The brief spell of faster inflation nonetheless left its mark on the rate for 1989 as a whole. Consumer prices rose by 6.3 per cent, one percentage point more than the increase recorded in 1988 and two points over the target.

Although activity slowed down in line with developments in the OECD countries as a whole, the Italian economy achieved growth of 3.2 per cent in GDP, 6.3 per cent in investment and 10.1 per cent in exports. Net of public consumption, the growth in domestic demand exceeded that in GDP by more than half a percentage point. The continuation of the economic expansion had a significant impact on the labour market. In the last two years employment has increased by more than 300,000 persons, nearly half of them in the South. The unemployment rate declined to 11.5 per cent this January.

The inflation differential and exchange rate trends caused a loss of competitiveness of 2.4 per cent on average for the year, but this did not damage Italy 's foreign trade performance. Exports almost equalled imports; exports grew faster than world trade, benefiting from an unexpectedly strong expansion of demand in the leading European economies. Most of the increase in the trade deficit, from 1.5 to 2.7 trillion lire, was attributable to oil imports.

The deterioration in the current account of the balance of payments was much more substantial. The current account recorded a deficit of 14.5 trillion lire, equivalent to 1.2 per cent of GDP, nearly twice the figure for 1988. The deterioration reflects the contraction in the surplus on invisibles that has been under way for some time. Net earnings from tourism again declined, by more than 1 trillion lire. The deficit on unrequited transfers, now running at over 3 trillion lire, reflects Italy's contribution to the EEC budget and aid to developing countries. Above all, the growing net external debt, stemming from accumulated current payment deficits, and high international interest rates have increased the net outflow of investment income to over 11 trillion lire, 2 trillion more than in 1988. Foreign capital inflows, which are no longer solely in the form of loans but increasingly in that of direct and portfolio investment, offset the current deficit and gave rise to a substantial increase in foreign cuffency reserves.

Monetary and exchange rate management

The restrictive monetary stance was tightened further in March 1989 by raising the discount rate by one point to 13.50 per cent.

Serious difficulty in meeting the Treasury's borrowing requirement arose early in the year. I described the problem and the way in which it was overcome in this forum last year. In June, when as expected the bringing-forward of the first instalment of income tax payments generated a public sector cash surplus, the Bank of Italy completed the outright sale of the securities it had purchased in March to make good the inadequacy of market demand. The absorption of liquidity was intensified, partly because bank lending continued to expand rapidly, reaching a twelve-month rate of over 21 per cent in the summer.

In October the Bundesbank tightened its monetary policy by raising the discount rate by one point, a move that was emulated by almost all the other European central banks. The international financial scene began to be influenced by events in Central and Eastern Europe.

In Italy, economic conditions did not call for a further increase in official interest rates. The lira had been appreciating since the last few months of 1988. Between the beginning of the new year and August, purchase interventions in the foreign exchange market by the Bank of Italy limited the rise in the effective exchange rate to 1.8 per cent overall and 2.7 per cent in relation to the other EEC currencies.

In the months that followed, the appreciation of the Deutschemark against the dollar and the markets' unfounded expectation that the adoption of the narrow margins of fluctuation would be used as an opportunity for a substantial devaluation of the lira led to outflows of capital. The lira appreciated against the dollar but declined by 2 per cent within the EMS; its overall effective exchange rate remained unchanged.

The demand for medium and long-term government securities dried up again from late October onwards. A larger share of the Treasury's borrowing requirement was met by issuing bills, on which the average gross yield rose by nearly one percentage point in the space of two months to a peak for the year of 13.7 per cent in November. In December, with the passage of the Finance Law for 1990, demand revived and interest rates tended downwards.

The Treasury's intermittent financing difficulties and uncertainty in international markets did not lead to any significant overexpansion of the money supply. Adjusting the data for distortions due to strikes in the banking sector in December, monetary base expanded at a twelve-month rate of 9.4 per cent and M2 at one of 9.3 per cent, in line with the growth in nomifial GDP. Monetary base creation took piace almost exclusively via the external sector; almost all of the state sector borrowing requirement was financed in the market.

Credit expansion far outpaced the growth in GDP and in investment. Lending to the non-state sector, which banks financed by disposing of government securities, increased by 18.5 per cent, compared with the originai forecast of no more than 10 per cent. The strong growth in credit can be ascribed in part to keener competition between credit intermediaries and in part to borrowing to finance purchases of real and financial assets.

The economy and economic policy in 1990 and beyond

In the first few months of 1990 a steady inflow of capital has kept the lira at the top of the EMS band of fluctuation and favoured a reduction in Italian interest rates, narrowing the differential in relation to world market rates. The Treasury has continued to meet its borrowing requirement in the market. Money supply growth has remained within the 6-9 per cent target range, while the expansion in lending has shown signs of slowing down.

Inflation has subsided. The twelve-month rise in the cost-of-living index has come down from the peak of 7 per cent recorded in June and July of last year to 5.7 per cent this May. The growth of domestic demand has proceeded at a more moderate pace, while investment and production have remained at satisfactory levels. The measures adopted by the Government on 18 May, which reduce the budget deficit for 1990 by almost 12 trillion lire, are aimed at ensuring that the ceiling of 133 trillion lire set in the Finance Law is exceeded by no more than 2.6 trillion. On 19 May the discount rate was lowered to 12.50 per cent. These measures were followed by a further easing of interest rates; at the Treasury bili auction at the end of May the average gross yield declined to 11.8 per cent.

Significant though it is, the progress to date is insufficient to eliminate the disparitier between Italy and the other leading participants in the exchange rate mechanism as regards inflation and the public finances. An extraordinary effort is required. All the componente of economic policy must play their part in maintaining the more rigorous stance implicit in Italy's dual commitment to the narrow exchange rate band and the unrestricted movement of capital. That we have managed to create the conditions in which these decisione could be taken today without running any immediate risk is no guarantee that we shall be able to honour this pledge in the future.

Even assuming no resurgence of external inflationary pressures, the rate of increase in prices will not decline further in the second half of 1990 unless labour costs reflect the intention to avoid upsetting the macroeconomic equilibrium expressed in the agreement reached by the two sides of industry in January. Even if inflation fell to 5 per cent by the end of the year, which is feasible, there would stili be a two-point differential vis-à-vis France and Germany. The hard core of inflation must be cracked.

It is in the field of nominai incomes, both wages and profits, that the strength to overcome inflation has to be mustered, and without delay. The only certain outcome of a wage-price spiral and leapfrogging wage claims is debasement of the currency and economic stagnation. We had bitter experience of this not so many years ago. The wage claims being made in the current round of public and private sector contract renewals in services and in industry are inconsistent with the inflation target set in the economic and financial planning document approved by the Government on 18 May. Wage increases must be brought more into line with productivity gains, not in order to leave room for wider profit margins but to improve competitiveness and thereby foster the growth of the entire economy, investment and employment, and to enable Italy to contribute to the consolidation of monetary stability in Europe, in the same way as Germany and France.

The public sector borrowing requirement net of interest payments and, to a lesser extent, the overall borrowing requirement both diminished as a proportion of national income in the second half of the eighties, but the public finances remain seriously out of balance. The public debt will soon exceed Italy's gross domestic product. The Government planning document sets the objective of reversing the trend in the ratio of debt to GDP by 1993, partly through sales of public assets. The pian proposes to achieve a budget surplus net of interest payments in 1991 and to work towards eliminating the deficit on current items. Only when this second, more important goal has been attained will dissaving by the public sector cease to offset saving by the private sector.

The ratio of tax revenues to GDP in Italy will approach the European average in 1990. Any further increase will have to come primarily from measures to reduce tax evasion and from revision of the criteria for determining taxable income.

Strict control of public spending is essential and no less urgent. In the short to medium term, however, expenditure is largely determined by past legislation and established practice, which set the level of benefits and services provided by the public sector. Reforms that have been promised for years stili await enactment, most notably those of the national health service and the social security system. Discretionary expenditure also needs to be curbed, on the basis of budgetary procedures that allow closer scrutiny of appropriations.

The completion of the single European market offers all member countries an opportunity to increase their prosperity. It will stimulate competition between national systems that transcends the competition between producers in the marketplace. In this competitive environment, some economies may not succeed in regaining lost ground and may even fall further behind; they would be marginalized in the integrated European Community.

Italy's foreign trade in goods and services displays many strong points, but in other respects it is already vuinerable, irrespective of the behaviour of prices and exchange rates. Since competition is now centred on research and the development of advanced production and organizational techniques, Italian industry runs the risk of falling behind in the most innovative areas, which will be sensitive to the removal of non-tariff barriers to international trade. International corporate strategies, with their increasing emphasis on takeovers, mergers and cooperation agreements, will also test Italian firms more severely.

In the services sector, Italy's transportation, telecommunications and financial services are giving cause for concern in proportion to their growing importance in intra-Community trade, and gross receipts from tourism are steadily declining in real terms.

Even where it is not directly exposed to foreign competition, the services sector has a decisive influence on the overall competitiveness of the economy owing to its increasing relative size and its closer links with manufacturing industry. This is true of private sector services and doubly so of public services.

The public sector affects the efficiency of the economy not only by providing services and managing public utilities but also through regulation and direct intervention, ranging from the enactment of technical standards for industrial products to the operation of transportation and communications networks, from the rules for public procurement to the sector 's influence on prices and from economic assistance for firms to the utilization of European Community funds. The damage to competitiveness caused by regulatory inadequacies and managerial inefficiency may not always be readily apparent, but in the long run it holds back the progress of the country.

The awareness that competition now relates more than ever to the economie system as a whole again raises the Southern question as a matter of urgency.

This has long been a concern of the Bank of Italy, which appreciates the civic and social dimension of the problem even though, for reasons of competence, it has confined itself to examining the economic and financial aspects of the question, as in the study described at length in last year's Report, the findings of which will be published shortly.

The South has advanced in absolute terms, although not with respect to the rest of the country. From the albeit uneven progress the area has made, it is clear that what is required is no longer income support, in other words the provision of additional transfer payments, but action to generate output and employment.

The restoration of efficient public administration — in the selection of public works projects, in the exercise of controls and even in everyday operations — is necessary throughout the country, but in the South it is crucial to development; it would strengthen confidence in state institutions and reduce the scope for improper forms of social behaviour and collective organization, which are open to infiltration by organized crime. The public infrastructure, which should be conceived increasingly as a nationwide and European network, must be made uniformly efficient throughout Italy, by overcoming poor coordination in investment and maintenance. The foundations for a robust market economy in the South lie in the emergence of local enterprises, which need to be promoted using instruments that are easy to apply and certain in their effect; however, firms located in the more developed parts of the country should also play their part. The commitment by enterprises must be matched by greater flexibility in costs and forms of employment to take account of the disparity in productivity that remains to be overcome.

Financially, the South of Italy does not suffer from the worst of the ills that are typical of underdeveloped areas, such as isolation from the national and international credit market or a Jack of financial resources for productive investment. The problem, as much in the private as in the public sector, lies more in the efficient utilization of the funds that are available. This leads us to emphasize the function of selection and evaluation that is proper to banking. Banks must provide modern services and combine their assessment of the borrower 's creditworthiness with that of the prospects of the investment project to be financed. The increased presence of national and international banking groups alongside locai credit institutions, further amalgamation and stili greater competition are necessary conditions for a continued narrowing of regional disparities in the cost of banking intermediation, greater interest rate uniformity and an acceleration in the pace of change.

Money, markets and the public debt

Central banks are responding to the rapid growth in economies and financial systems by adapting procedures, instruments and institutional arrangements; this strengthens and clarifies the link between the functions they perform with regard to monetary policy, the payment system and banking supervision; that link operates through the money created by the central bank.

By regulating the monetary base and the interest rates at which it is supplied to the market, the central bank fulfils its monetary policy responsibilities with regard to price stability and control of the economic cycle. But central-bank money, the lever of centrai bank intervention because it provides the base for deposits and credit, is also the fulcrum of the payment system, since it is the only instrument by which payment obligations can be extinguished immediately and finally: among the public by transfers of banknotes, and between credit institutions by means of debits and credits on accounts with the central bank. When the central bank is also given supervisory responsibilities, action to ensure the stability of the credit system and improve its structure enhance the effectiveness of monetary management and the efficiency of the payment system.

Monetary policy

The experience of the last twenty years, in which the stagflation of the seventies was followed in the eighties by prolonged growth coupled with disinflation, has strengthened in everybody the conviction that price stability is a prerequisite of rapid development. Our satisfaction with the progress made so far is tempered by awareness that the path stili to be travelled is neither short nor easy.

The renewed vigour of the economy and the credibility acquired in the management of the lira during the ten years of participation in the EMS are the factors underpinning the stability of the exchange rate today. This stability accentuates the effect of the nominai interest rate differential, which basically reflects the difference between expected rates of inflation, and fosters inflows of foreign capitai and a decline in domestic interest rates. The public finances and the economy as a whole benefit. This sequence can be repeated — in theory, until the differential between Italian and foreign yields has been eliminated — provided economic policy sustains confidence, by curbing the budget deficit, holding down domestic cost increases and reducing inflation. Otherwise, the credibility of the exchange rate is undermined, making it necessary to adopt a tighter monetary policy and thus restoring the interest rate differential. In the market for twelvemonth Euro-currency deposits the spread between the rate on lira assets and the average for those denominated in the other ERM currencies amounted to more than four percentage points in 1988; today it is half that figure.

In the past the dose correspondence in each country between the financial instruments held by residents, those intermediated by institutions operating in the domestic market and those denominated in the national currency facilitated the definition and control of monetary aggregates and the identification of a stable relationship between these and economic activity and prices. The premises on which this correspondence was based are now being eroded. Complete freedom of capital movements and stable exchange rates are causing the currency and credit of each country to be used increasingly outside its frontiers, a point already reached by Germany. This phenomenon has not yet assumed significant proportions in the case of Italy, but it may do so in the future. Each central bank will be less and less able to determine the monetary conditions in its own country.

On the other hand, no matter how strong its currency and underlying economy, no one central bank will be able to determine the monetary conditions in the whole European Economic Community; these will have to be the result of coordinated action. Community monetary policy will rely on quantitative targets to provide the nominai anchor needed to ensure price stability. Later this year the Committee of Governors of the EEC central banks will begin to coordinate the formulation of monetary policy more closely, a step we had been advocating for some time; in this way the first phase of economie and monetary union will begin to take on substance.

The prospect that all forms of automatic monetary financing of budget deficits within the Community will be prohibited will make it necessary to review the limits and procedures applying to the Treasury's current account with the Bank of Italy. During the eighties the ratio of the overdraft on this account to the total monetary base doubled to 40 per cent. The elimination of automatic Treasury access to central bank financing also has important implications for the reform of compulsory reserves; in the control of the money supply, the high rate of such reserves has acted in the past as a counterweight to the growth in the Treasury's overdraft.

The payment system

The Bank of Italy's programme for the payment system, which is being implemented in cooperation with the banks, is designed to achieve time and cost savings, improvements in the quality of services, and greater security and reliability. It is based on the belief that the administrative and technological procedures for transferring money are an essential support for the whole economie and financial system and an increasingly important aspect of competition in banking.

In the field of customer services, the channelling of out-of-town cheques to the clearing houses has obliged banks to standardize their practices and permitted a sizable reduction in handling times. Last year two hundred million out-of-town cheques, or one third of the total number paid, were handled with the new procedure, which had been introduced at the end of 1988. The technique of cheque truncation, whereby payment details are transmitted electronically, is now being introduced and is expected to bring further improvements in efficiency.

The new procedure for clearing and settling interbank payments via the screen-based circuit linking all the major banks and the Bank of Italy was brought finto operation during the year. In April the gross volume of transactions cleared with the new procedure amounted to 1,200 trillion lire, two and a half times the figure recorded a year earlier. The reorganization has produced time and cost savings and increased the number of operations settled in monetary base, with the improved certainty and transparency this brings.

The link between the mechanisms involved in the circulation of money and the procedures for controlling its quantity can be seen more clearly today. The screen-based circuit has made it possible to increase the number of participants in the money market, expand trading and extend business to the afternoon, as in the other leading countries; the importance of banks' day-to-day liquidity management has increased. The refinancing provided by the central bank continues to perform an indispensable function in the settlement phase. Two other innovations will enhance the banks' ability to procure liquid funds: the screen-based market for interbank deposits, which carne finto operation in February of this year and on which daily turnover has exceeded 4 trillion lire; and the possibility for banks to mobilize part of their compulsory reserves, which should take effect in September. Taken together, these developments are expected to improve the significance of short-term interest rates and speed up the transmission of the monetary policy impulses imparted by the central bank.

The relationship between the payment system and banking stability is also becoming more explicit. The adoption of multilateral clearing for transactions previously settled on a bilateral basis has reduced the credit balances on correspondent accounts; the growth in interbank daylight overdrafts and the increase in the number of participants may heighten the risk that one bank's failure to settle will prove contagious. In Italy the problem has stili not reached the proportions evident in the other major countries, and countermeasures are being prepared that take account of experience elsewhere.

The steps taken in the payments field are also necessary from the international point of view. The problems of management and risk control associated with clearing are more complex when this involves foreign currencies and intermediaries in different countries, not least because of the time differences in what has become a single global market operating round the clock. The central banks of the Group of Ten countries are studying these issues at the BIS: they are dose to agreement on generai principles for the operation and surveillance of international clearing systems, but satisfactory levels of efficiency and security are unlikely to be achieved unless the leading central banks adopt common procedures.

The financial markets and the public debt

The Italian financial system has successfully handled a shift in savings on a scale unparalleled in other industrial countries. At the beginning of the seventies the flow of financing to the public sector was comparatile to that to the company sector; now it is almost twice as large. The shift has occurred increasingly in the financial markets, the predominance of the banking system has been diminished and the amount of double intermediation via the credit system has been reduced. Households' direct holdings of government securities have risen to over 30 per cent of their total financial assets.

International comparison reveals the extent to which Italy's securities markets are affected by the size of budget deficits and the experience of inflation, as reflected in the high proportion of short-term and floating rate paper, the size of the primary markets compared with the secondary markets and the prevalence of government stock. Gross annual issues of government securities are equivalent to 50 per cent of GDP, as against 3 per cent in the Federal Republic of Germany, 5 per cent in the United Kingdom and 10 per cent in France. The markets for private sector securities are stili thin and the range of transactions is limited, partly for tax and organizational reasons.

In the longer established financial centres a large proportion of households' financial wealth is channelled through and managed by institutional investors: about 30 per cent in the Federal Republic of Germany and the United States and 50 per cent in the United Kingdom. By contrast, the Italian market has to take account of the predominance of individuai investors, who are averse to risk and prefer investments that can be valued immediately and are simple to manage.

With a public debt the size of Italy's, decisione as to the types of instrument to offer and the frequency, methods and markets of issue have to be directed above all to minimizing the cost of borrowing while simultaneously lengthening the average maturity, for any given monetary and fiscal policy mix.

To reconcile the conflict between these two objectives, the Treasury has made extensive recourse to floating rate securities: Treasury credit certificates account for 60 per cent of the medium and long-term component of the public debt. In line with the policy pursued in other countries — and all the more necessary in Italy, where 56 per cent of all government paper is held by households — the Treasury has made only limited use of sophisticated securities in widening its range of instruments. The task of meeting the demand for such securities is entrusted largely to the secondary market. In order to reduce the segmentation of this market, the technique of auctioning stocks in several tranches was adopted last year after some tax difficulties had been overcome.

After lengthening from one to four years between 1980 and 1987, the average maturity of the public debt has gradually shortened again, partly owing to the acceleration in inflation, and now stands at two and a half years. Longer maturities provide relief from the trouble of constant renewals and reduce the predominance of the primary market, leaving room for the secondary market to grow and easing the constraints on monetary policy. Gross issues are now so large that if 20 per cent of a single month's offerings remained unsubscribed, the monetary base created would be equal to the target for the whole year.

The relative cost considerations that until recently virtually precluded issues of long-term fixed rate securities are changing. An economic policy that keeps the lira within the narrow fluctuation band will foster the convergence of interest rates and tend to reduce the cost of lengthening maturities. The success of yesterday's issue of seven-year Treasury bonds is an encouraging sign; the last public issue of fixed rate securities with a maturity of more than five years was made over fifteen years ago.

Despite the difficulties arising from the state of the public finances, the Treasury has held down the cost of the public debt, thanks in part to innovations and improvements in management techniques. The abolition of the floor price for Treasury bili auctions was a major advance, and had positive repercussions on medium-term floating rate securities as well. Opportunities for further progress are to be exploited where they exist. However, for a given level of international interest rates, the interest burden can be really eased only by an economic policy that achieves significant budget surpluses net of interest payments and a lasting fall in the rate of inflation.

The complete liberalization of foreign exchange transactions will encourage the concentration of trading in the most efficient financial centres and foster greater uniformity in practices and financial structures. Where the market is located is not unimportant; a market is not simply a piace for making exchanges, but an organization that produces services and hence income and employment; it is an industry, which incorporates the technical know-how, working practices and professional skills best suited to the requirements of the economy in which and for which they have developed.

Major innovations have been introduced in Italy in the trading of government securities, in procedures for centralizing shares and Treasury paper and in the settlement of securities contracts. Daily turnover on the screen-based market for government securities has risen to 2 trillion lire in the last few weeks, eight times the level of a year ago. Monte Titoli now administers 80 per cent of the shares in circulation, excluding those held by controlling syndicates. The corresponding figure for government securities deposited with the centralized system operated by the Bank of Italy is over 90 per cent. The new procedure for the settlement of securities contracts, which was introduced last year, means that the majority of transactions are now settled without the physical movement of certificates.

The Italian financial market nonetheless continues to display weaknesses in comparison with other Community markets, with the attendant risk of business moving abroad. Despite the withholding tax penalty, this has not happened for money market instruments or interbank funds, in part because of the obstacles previously posed by exchange controls. On the other hand, the volume of trading in some leading Italian shares in London is equal to about one third of that on the Milan Stock Exchange, on which no foreign shares are listed. Steps to strengthen the Italian market and put it on an international footing will have to be taken on several fronts: in the tax field, by cutting the tax on transactions and reducing the disparity of treatment between different kinds of financial asset; as regards the legai framework, by redefining the role and status of securities intermediaries, reformulating dealing rules, regulating takeover bids and making insider trading a punishable offence; at the technical and organizational level, by requiring dealers to comply more rapidly with the recommendations of the Consob regarding the creation of a screen-based stock market and the reorganization of settlement services.

Listed companies represent only 20 per cent of the capitai of all Italian limited companies and, as a ratio to GDP, their average capitalization is far less than in the other leading industrial countries. The extension of the list can come from companies turning to the market in order to expand their capitai bases and operations, credit institutions and other public sector enterprises adopting the form of limited companies and the sale of state-owned shareholdings. It is above all in the share market that the small role of institutional investors is most striking. The development of supplementary funded pension schemes, desirable in itself for the purpose of rationalizing the social security system, would significantly bolster the share market.

Exchange liberalization and financial integration

Controls and restrictions on foreign transactions have been a virtually constant feature of Italian law ever since the Italian state was founded. The foreign exchange reform of 1988 preserved the exchange monopoly but gave companies ampie room to operate and almost completely abolished the authorizational function of administrative bodies, with the thousands of authorizations to which it had given rise every year. This month Italy crossed the border from a system that was stili restricted to one with complete freedom of exchange.

Under the new legislation residente can choose whether to transact their business via Italian or foreign credit institutions. Households are now allowed to hold accounts abroad and foreign currency accounts in Italy, while companies can use innovative instruments in their foreign exchange management. Banks can take both net creditor external positions and foreign exchange spot and forward positions, subject only to prudential considerations; they can also lend freely in lire to non-residents and offer new products for the management of exchange and interest rate risks.

The single European market and competition between national systems

Freedom of capitai movements is now a reality, while the freedom to provide banking and financial services will become fully operative at the beginning of 1993. The main components of the Community legislation needed for the creation of the single market have now been defined.

We have entered a new phase, in which the right of households and businesses to purchase financial assets and services anywhere in the large market gives rise to competition not only between individuai intermediaries but also between national legai and tax systems, labour contracts and the technical standards and instruments common to each financial market. In some respects this situation is unparalleled even in the legai systems of existing federal states, where economie integration is combined with much more extensive legislative and governmental machinery at the central level than in the Community. In the competition between systems, even small competitive disadvantages in terms of costs, rigidity, regulation and quality of service will significantly affect flows of funds and the distribution of the financial services industry.

The aim of the legislation that is being enacted is to improve Italy 's ability to meet the international challenge. Three bills, now at an advanced stage of parliamentary examination, will allow public-law banks to become limited companies, complete the legislative framework for the supervision of banking groups, encourage mergers between banks, protect banks' autonomy vis-à-vis non-financial firms, regulate securities business by any category of intermediary and diversify the market. Two other bills to be examined shortly by Parliament propose to rationalize agricultural and real estate credit.

Once these laws have been approved, it will be necessary to regulate the ending and fund-raising activities of non-bank entities, the main gap left in the law. The regulation of such enterprises, albeit less extensive than that of banks, will permit more uniform conditions of competition and investor protection to be created. It is also necessary in order to comply with the Community's Second Directive on Banking Coordination, which allows the financial subsidiaries of a credit institution access to the single market only if they are subject to separate prudential supervision.

Taxation is another field in which national systems are in competition. Minima) Community harmonization of the taxation of savings income has proved impossible, not least because unanimity is required in fiscal matters. As things now stand, freedom to provide financial services and free movement of capital tend to cause a downward alignment of taxation, both because those liable to tax will withdraw their assets from high-tax countries and as a result of competitive reductions in tax rates. This is not equitable; it distorts the allocation of savings, as well as the selection of the ideal financial market as a result of competition between different regulatory systems, and it conflicts with the will of the majority of member countries. It is to be hoped that the obstacles which have so far blocked the necessary tax harmonization measures will be removed. Seeking to achieve this objective does not absolve Italy from carrying out a generai revision of its own system for taxing financial activities to prevent Italian intermediaries and markets from being kept at a competitive disadvantage within the Community in terms of onerous tax rates and administrative procedures and from the point of view of the neutrality, certainty and simplicity of taxes.

Labour costs and legislation on employment conditions constitute a third area of competition, of considerable importane for a labour-intensive activity such as banking, especially at a time when banks are restructuring and changing the ways in which they provide services. Italian banks have some of the highest labour costs in Europe and some of the most rigid rules on demarcation and mobility; these conditions reduce their ability to compete both in Italy and abroad.

Finally, competitiveness depends on the efficiency and quality of elements that are common to the entire financial sector, even if not on a compulsory basis: the generai conditions of customer contracts, operating practices, technical requisites for service networks, information rules and deposit protection schemes. In these areas the Bank of Italy provides stimulus and guidance in varying degrees, depending on the issue, but it is the banking associations, notably the Italian Bankers' Association, and the banks themselves that must make the running. The more the banks, in their own long-term interest, seek to make the common systems work efficiently, the greater will be the cost and flexibility benefits of the solutions adopted.

Credit institutions and supervisory activity

The far larger size, increasing competition and fewer regulatory barriers of the market today mean that credit institutions have a wider range of options, but also less protection; there are greater opportunities, but at the same time the risks are higher and differences in efficiency have a more marked effect.

Rapid market integration and exchange control liberalization increase the scope for major banks to expand their international operations and alter their cost-benefit considerations. The constraint imposed by the availability of financial and human capital requires banks to reassess many aspects of their foreign operations in the light of strict criteria of viability: what kinds of establishment to have and where, which products to promote, and how to organize the links with head office.

The rapid growth in the demand for modern financial services and the removal of restrictions on branch networks are also leading banks to review the supply of services. The location of branches and the choice of products to offer will depend increasingly on the quality and cost of services and on the extent to which they meet the specific needs of well-defined categories of customer.

The changes taking piace have implications not only for banks' strategies but also for the risks they will have to face. In addition to the possibility of insolvency on the part of debtors, market risks are taking new forms. Exchange risk is bound to increase owing to the growth in the demand for foreign currency transactions, the rise in the volume of foreign exchange business and banks' greater activity for their own account following the liberalization of foreign exchange transactions. Interest rate risk reflects not only maturity transformation but also the greater variability of rates and the credit institutions ' diminished market power to fix their deposit and lending rates, which are increasingly correlated with those of the financial markets. Liquidity risk is being attenuated by the improvements in the efficiency of the money market, but has been affected by the shift in the composition of banks' balance sheets. Between 1987 and 1989 securities and other immediately realizable assets decreased in relation to deposits from 22 to 15 per cent, while there was an increase in sight liabilities and off-balance-sheet commitments, with those in the form of undrawn customer credit facilities rising from 57 to 89 per cent of deposits.

These developments cali for determination on the part of professionally qualified managers: to improve the techniques of risk evaluation, provide banks with commensurate reserves and liquidity and strengthen their organization and internai controls. Observation shows that Italian banks have adopted a wide variety of organizational solutions, which is not in itself a drawback since no single formula can be said to be preferable in every respect; it also reveals cases in which there is urgent need for remedial action owing to the Jack of a clear overall plan, failure to comply with rational criteria or an inadeguate level of security.

Faced with market integration and financial innovation, the Italian credit system has shortcomings to make good, but it can count on major strengths, including a solid capital base and the fact that it is part of a dynamic economy with a private sector propensity to save that remains one of the highest in the world. The most serious problem is the short time left, which is aggravated by the need to reorganize on a large scale.

The trend towards more uniform interest rates has been coupled with an increase in the dispersion of banks' profitability. In the last three years both large and small banks have seen their shares of the credit market change at an increasing pace, encouraged by the high level of demand, the elimination of the ceiling on bank lending and the introduction of capital adequacy ratios; the liberalization of branch networks is now generating additional stimulus for change. Keener competition was expected to have this effect, which will be beneficiai for the system as a whole. However, reorganizing the sector exclusively by this means — ultimately through the declive and collapse of the weakest institutions — would involve higher social costs and a greater threat to the stability of the system than if timely mergers were to make a significant contribution.

The supervisory activity of the Bank of Italy both influences and is influenced by the changes taking piace. This activity increasingly consists in quantifying and circumscribing banks' total risks and evaluating their organization and internai procedures with the aim of ensuring prudent management.

All the restrictions on the opening of branch offices were lifted in March, leaving banks entirely responsible for assessing the opportunities for operating profitably in each locality. Reference to the criterion of "economic need" has been dropped; the Bank of Italy intervenes only when the expansion plans submitted by individuai banks are incompatible with their technical and organizational capabilities. Banks will be permitted to participate in securities underwriting syndicates in accordance with generai regulations on the limitation of risks; all geographical restrictions on their lending have been lifted. Accordingly, the complete elimination of authorizations for ordinary operations is now in sight; in the future authorization will apply only to the key aspects of a bank's life: its establishment, amendments to its statutes, changes in ownership, significant participations and mergers.

Quantitative standards such as capital adequacy ratios, the instruments used at the first level of prudential control, permit balance sheet flexibility and alloca different categories of risk to be offset; on the other hand, they can be applied restrictively to banks whose situation makes it advisable to limit the new risks they can take on. In the coming months the capital adequacy ratios will be modified to bring them finto line with Community law and the international agreements signed since they were introduced, and to take account of the greater exchange risks that can be taken on as a result of the removal of exchange controls. When the Community Directives are given effect in Italian law, the application of the capitai adequacy ratios will be extended to special credit institutions and banking groups.

The supervision of credit institutions cannot be based exclusively on quantitative rules, however. They have to be part of a system for the overall assessment of operations based on substantial accounting and other information, the flow of which has recently been supplemented. It is the duty and responsibility of bank managements to ensure that returns are reliable and correspond to the facts. Their veracity is safeguarded by a Law of 1986, which makes it a penai offence to provide information that misrepresents a company's situation. The collection of information is completed by inspections, which are necessarily intermittent; they provide an indispensable check and the techniques used are being improved with the aim of making more frequent and selective controls.

The analysis of prudential returns will increasingly be accompanied by a dialogue between the supervisory department and bank managements to identify problems and discuss the corrective action banks intend to take. The scope of the tasks entrusted to the branches of the Bank of Italy will be widened.

Supervisory activity can reduce the probability of crises, but not prevent them entirely: competitive selection has to extend to the elimination of firms from the market. The responsibility of banks' governing organs and the importane of their professional competence increase. The prorogation of appointments in public sector banks undermines the confidence and commitment of the persons concerned, makes the implementation of policies and programmes uncertain and reduces competitiveness.

In addition to striving to promote the stability and efficiency of the credit system, the Bank of Italy has called for a positive response to the danger of involvement in financial operations of doubtful legality and for full cooperation with the authorities responsible for repressing criminal activities; as I pointed out six years ago, in doing so the credit system will both perform its duty to the country and defend its own integrity. The dimension of the problem is international; with capital mobility increasing, the threat can only be countered effectively by fully coordinating national laws and measures. On the basis of the statement of principles adopted by the Committee of Governors of the Group of Ten countries in December 1988, generai guidelines have been formulated in various international fora and are now being incorporated irto national legislation. Arrangements and procedures to give operational effect to international cooperation are being agreed. Italy has recently introduced legislation providing for penai sanctions for the laundering and investment of the proceeds of criminal activities.

The world scene has changed rapidly and profoundly since last year's meeting; an opportunity has arisen to establish an international order based more firmly on the ride of law and on cooperation. The countries of Central and Eastern Europe are experiencing both the elation and the birthpangs of freedom; they face grave difficulties, made more complex by the transition. In addition to its economic aspects, the transformation now taking piace affects and centres on citizens and society. Not only must new ways of organizing the economy be devised, but new models of society must be developed; these cannot be transposed from elsewhere but must grow from locai roots, from the culture and traditions of each people.

The European Economic Community is playing a part in these tumultuous events, helping to shape developments and consciously serving as a point of reference. It is establishing association agreements with the countries of Central and Eastern Europe, supporting German unification, accelerating the construction of its own economic and monetary union and laying the foundations for political union, which has been the ultimate objective from the very outset. The Community must give economic substance to its willingness to become involved in international affairs by generating greater savings.

The developing Community does not suppress states and nations, just as a state respectful of the rights of its citizens does not stifle the energies of the individuals, associations and groupings of which it is composed, but nurtures them. The European Community on the one hand and the member states on the other provide a framework and a guarantee for freedom, security and competition. The European Community allows all the participating countries to compete not only in the goods produced by their enterprises, but also in every field of policy and action; in this way it disciplines and also encourages the activity of member states. The competition among economic systems and regulatory arrangements, which we have made the centrai theme of these concluding remarks, will be the hallmark of Community activity in the years to come.

In recent months Italy has realized two objectives it has long striven to achieve: the adoption of the narrow EMS margins of fluctuation for the lira and the complete liberalization of foreign exchange transactions. These accomplishments, which are the culmination of a policy tenaciously pursued, permit us to participate fully in the construction of the European Community. If we are to hold our own in the EC, however, there is stili much to do, and much ground to be made up in both legislation and administration; if we failed in this, we would risk finding ourselves in a position of inferiority in the very edifice we are helping to build.

The urgent tasks facing us are to restore sound public finances and defeat inflation. With monetary policy soon to be conducted at the European level, national budgetary policy and the behaviour of incomes are the factors that will determine whether a country advances rapidly or slowly within the integrated European area.

The proper functioning of the public sector, at both centrai and local levels, is crucial to the advancement of an economy and of society as a whole. In Italy the public sector is afflicted by serious disequilibria, the contrast with neighbouring countries is more pronounced and the resistance to the necessary correttive measures stronger, despite their being clearly identified, acknowledged and proclaimed. It is not just a quantitative problem, a problem of excessive deficits; there is a demand for better services, fair taxation and the rewarding of merit. The document approved a few days ago by the Government describes the country 's budget problems in their entirety, indicates solutions and objectives and establishes a timetable for action; existing Community commitments and those that will come finto operation in the immediate future admit of no delay.

In the countries that have successfully combined employment growth and price stability, incomes policy has played a decisive part, not through the imposition of artificial and hence ineffectual administrative constraints, but primarily through the conduct of the public sector itself as a major employer and through the attention it pays to the macroeconomic effects of private wage negotiations in order to preserve the necessary equilibria. Italy must conform to this model.

Italy is not condemned to live for ever with persistent inflation, run-down and inadeguate public services and a backward South. They are ills that can be cured, and cured rapidly, by drawing on the strengths and resources the country possesses. The continuation of favourable economic conditions and the perception of the immediate and future benefits should prompt us to take the action society demands, of our own accord and not at the urging of others. The conviction that such action must be taken motivates the Bank of Italy in the performance of its institutional tasks.